LOCAL INCOME TAX

A STUDY OF THE OPTIONS

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INTRODUCTION

This report is concerned with the likely practical implications of a local income tax in the United Kingdom: that is, an arrangement under which UK local authorities are authorised to charge a tax on personal incomes.[1]

The report does not try to argue the case, whether a local income tax is or is not desirable. There has been - and undoubtedly will continue to be - much debate about how far local authorities should be free to decide their own spending and other priorities within their own areas, or should rather work within national standards and policies, centrally determined; how far local authorities can genuinely be free to decide their own spending priorities, if they do not have a matching freedom to raise - in their own right, and not as pensioners of central government - at least a substantial proportion of their own revenues; how far, if local authorities were given more responsibility to raise taxes locally, they would become more accountable to their local electorates, not only for what their money is spent on, but also for how it is spent efficiently and cost-effectively; and whether it is appropriate to place in the hands of local authorities a tax as buoyant and as sensitive as an income tax.

Central government is, of course, concerned not only with its relationship with local government, but also with wider aspects. Even in the strictly fiscal area, it needs to consider how far it sees itself as responsible for the overall level of the public services (including both central and local provision); it needs to consider the possible effects of local taxation for the tax system as a whole, and for the distribution of incomes; and, more widely, it needs to consider the possible implications of local government expenditure and taxation for the use of domestic economic resources (and for international investment), and for economic management generally.

These are all matters for political choice; and on many of them successive governments have for many years struggled to reconcile principle with practice.[2] Experience of the Community Charge has affected both perceptions and reactions, possibly only in the short

term, possibly in a more lasting way. This report leaves that debate on one side. Suppose that a local income tax is thought desirable in principle - or at least is not ruled out. Suppose that the tax is seen, not necessarily as an alternative to existing local taxes, such as the Council Tax (as in most earlier discussions), but possibly as a supplement to them (as some might argue might be the better course, in the light of hard-won experience of the difficulties of placing too much weight on any single local tax base). What form or forms might it take? What are the main options? What would they be likely to entail? How far would each option achieve the likely main objectives, or avoid the main problems?

For the analysis, this report assumes that a local income tax could be reasonably substantial; yielding enough to make it reasonably worth collecting, over and above the national income tax, but not so large as to overshadow the national income tax itself. As an illustration, suppose that the tax was intended to finance something between 30 per cent and 40 per cent of local authority expenditure; so that, in combination with the Council Tax, it could finance something like one-half of the local authority total. The tax would then need to raise something between £15bn and £20bn or so (1991-92 estimates, Great Britain), equivalent to half or more of the present level of central government grants. The rates of tax might need to cluster around something in the region of 6p or so in the £, for the less ambitious objective, up to something in the region of 9p or so in the £. A local income tax within this range would not be out of line with the range of local income tax rates in many other countries.

Figure 1 overleaf illustrates the extent to which the pattern of local expenditure, and the main sources of local finance, in England and Wales vary as between one country and region and another. In particular, it illustrates the extent to which:

- there is a wide variation in the amount which each country or region spends, or receives in revenue (so that, for example, the West Midlands spends more than three times as much as East Anglia, but less than a third as much as the South East); but

- there is a much more consistent pattern, within each country and

region, as between the relative importance of different sources of finance (so that, for example, in the West Midlands expenditure accounts for some 10 per cent. of the total for England and Wales, and the different main sources of finance all fall within a range of 7 to 11 per cent of the England and Wales total).

The comparisons need to be handled with caution, as the figures are subject to some fairly significant differences of definition and approach.[3] They should not be interpreted as indicating more than, at most, some broad orders of magnitude. For what they are worth, the figures suggest that, at this level, the unevenness of income between regions - and the consequent need for some effective equalisation measures - is not out of line with that of other possible sources of local revenue, including the non-domestic rate. Comparable figures are not available for all existing, and possible new, local authorities below the national and regional levels; but it is reasonably clear that, as always, the local variation - and the uncertainty - tends to be greater, as one looks at smaller and smaller local areas.

At this stage, for the illustrative analysis, the study assumes that a local income tax could be in addition to existing local sources of revenue,[4] and in place of an equivalent amount of central government grant. Those assumptions would imply that a local income tax need not necessarily mean:

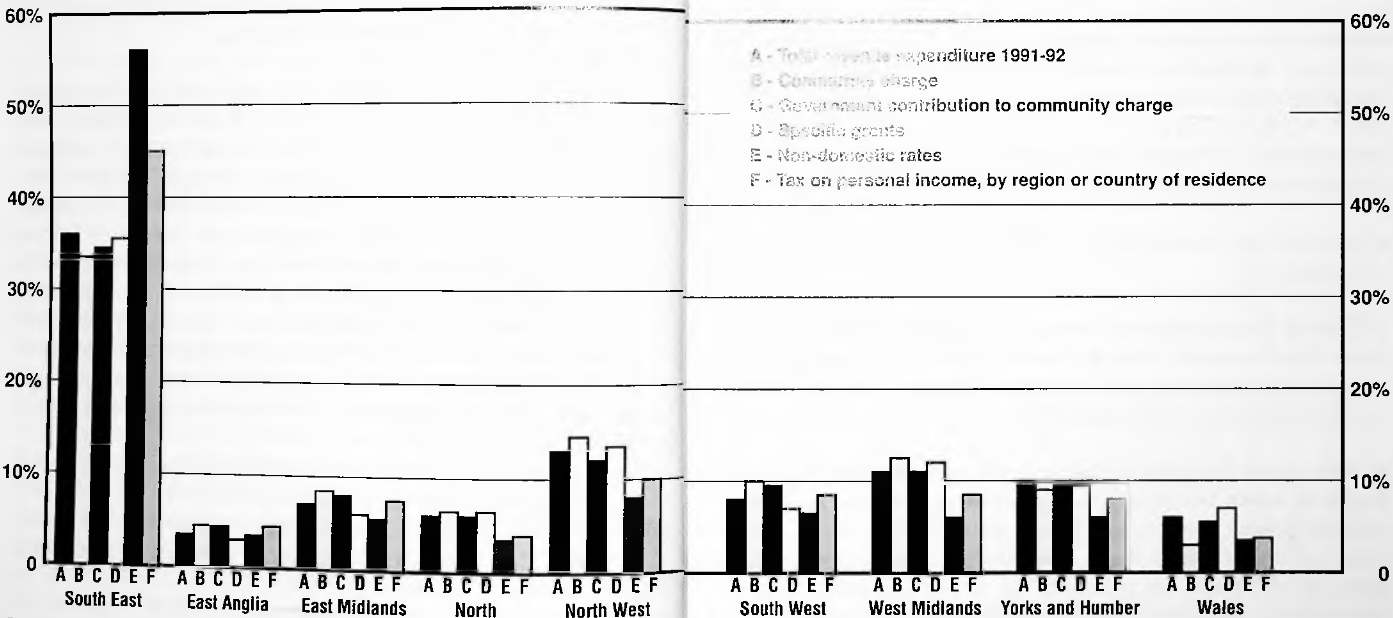
- A significant change in the overall (national plus local) burden of income tax, or of course of taxation as a whole;

- A significant change in the overall balance between direct and indirect taxation;

- A significant change in the overall balance between the taxation of unincorporated businesses (subject to income tax) and companies (subject to corporation tax, which is assumed to remain a central government tax).

That said, there would, of course, necessarily be increases or reductions in income tax in individual local authority areas, unless

Figure 1
Local Authority expenditure and finance in the English Regions and Wales, as a percentage of the England and Wales totals (see appendix, Table 2)



Sources as in Appendix, Tables 1 to 3

every local authority imposed the same rate.

Obviously, these are not necessary assumptions. Nor do any precise consequences necessarily follow from those assumptions. Central government would always be free to increase or reduce any individual tax, or to alter the balance between taxes as it thought good from time to time. But the assumption of a broadly revenue-neutral change in income tax may conveniently help to separate a further set of political questions (who should pay how much tax?) from the questions with which this study is concerned (how could local authorities join in taxing individuals' incomes?).

This report does not discuss in detail the case for a local charge on capital gains. It could be argued that in economic principle (real) gains are included in the classic definition of income; and in practice some people have a degree of choice, whether to take an accretion of wealth in the legal form of income or gain. On the other hand, gains are smaller in total and much more uneven in incidence than most other forms of income. The practical implications are not likely to be decisive.

On this basis this report:

- Reviews six main possible options for a form of local income tax, with possible variants (Chapter 1);

• Sets the options for change in the context of the (unusual, but not unique) UK system for taxing employment and other income, and its possible future development (Chapter 2);

• Identifies seven main criteria by which a local income tax might be judged, which have featured more or less prominently in earlier discussions (Chapter 3);

• Comments on the special issues concerned with residence for a local income tax (Chapter 4);

• Measures the possible main options against these seven criteria (Chapters 6-10);

• Looks at the implications that might be drawn from the way that some other countries arrange their local income taxes, given full weight to the limitations, as well as to the relevance of international comparisons of this kind (Chapter 11);

• Tries to pull the analysis together, and identifies options which might be worth thinking about, recognising that any attempt to estimate precise costs, or any precise timetable for change, would need to await much more detailed study by policy and management teams (as necessary) in the offices that would be operationally concerned - the Inland Revenue, the Department of the Environment and the Scottish and Welsh Offices, the local authorities and employers (Chapter 12: Summary).

Notes

1 The paper generally uses the term 'local authorities' to include - for the sake of brevity and simplicity - States and Provinces in a Federal constitution as well as second-tier authorities in a unitary constitution; and it does not, except where it is important for the argument, take time to list the different types of authority in full.

2 See, for example the discussion in Chapters 1 and 2 of the Green Paper Alternatives to Domestic Rates, Cmnd. 8449, 1981.

3 The figures underlying Figure 1 are given in Tables 1 to 3 of the appendix, together with some summary figures for Scotland and Great Britain.

4 In principle, this could imply either that each individual local authority should charge an income tax in addition to its existing source of revenue (such as the Council Tax), or that one tier of local government should be given more or less exclusive right to charge the existing Council Tax, or any successor to that tax, and another tier of local government should have the right to charge a new local income tax.

CHAPTER 1

POSSIBLE FORMS OF LOCAL INCOME TAX

AS THE EARLIER STUDIES make clear, there is no single, unique, form of local income tax. There is a range of very different possibilities each with very different costs. They can perhaps conveniently be grouped into 6 main sets of options, starting at one end with a minimal local element and a maximum of central government management and control, and finishing at the other end with a wholly free-standing local tax, entirely independent of the central government bureaucracy and the national tax system.

Option A: An hypothecated income tax

Under this approach, there is no separate local tax on incomes; and local authorities have no direct responsibility for the amount of tax to be charged, or for its assessment and collection. Rather, the legislation provides that a predetermined flat-rate amount (xp in the £) of the national income tax is to be levied on behalf of local authorities and is to be paid out to them (on some more or less complex formula) to finance local authority expenditure.

Option B: A 'Layfield' or mixed local surcharge and hypothecated income tax

Under this approach:[1]

- The tax on investment income remains a purely hypothecated tax (as in Option A), for which local authorities carry no policy or management responsibility; but

- Local authorities are responsible for setting the rates of tax on employment and self-employment income; and people resident in different local authority areas pay different amounts of tax on their

earned incomes accordingly. However, local responsibility stops there, as a surcharge on the national income tax. The tax is administered by the Inland Revenue, alongside the national income tax, retaining broadly the present PAYE arrangements, and on the same tax base. It is deducted by the employer or paid by the taxpayer, at the same time as the national income tax, and is wrapped up in the same remittance to the Inland Revenue. The Inland Revenue does not account to local authorities for the precise sums paid to it by or on behalf of their resident taxpayers, but makes a lump sum settlement with each local authority on the basis of the local rate of tax and a statistical (sample) estimate of the total amount of taxable incomes in each area.

Option C: A local surcharge on the national income tax

Under this approach, local authorities charge local income tax at local rates on all income: not only on earned income (as in Option B), but also on investment income. As in Option B, the tax is administered by the Inland Revenue on behalf of local authorities.

Option D: A local income tax, collected locally, on the basis of income as reported to the Inland Revenue

Under this approach, local authorities are responsible for setting the rates of tax on all earned and investment income (as in Option C). The tax continues to be charged on the same basis as the national income tax, (again as in Option C). By contrast with Option C, however, the local authorities, not the national Inland Revenue, are responsible for charging and collecting the correct amount of local income tax from their locally resident taxpayers. The Revenue is responsible for determining an individual's total income (both the amounts of income and any claims for reliefs or allowances); and this itself is assumed to imply a significant change in its present PAYE arrangements. The Revenue is also responsible for communicating that information to local authorities. However, its responsibility for local income tax goes no further than that.

Option E: A local income tax, collected locally on information reported locally, but on a national tax base

Under this approach, local authorities have full responsibility, not

only for setting the rates of tax, and for assessing and collecting it from the taxpayer or the employer, but also for establishing the necessary facts about taxable income - including the issue of any necessary personal local income tax return. The Inland Revenue has no responsibility for local income tax and is not responsible for providing local authorities with information about taxpayers' incomes. Under this option, however, local authorities are not free to depart from the national tax base - to grant tax reliefs which are not part of the national tax system, or to withhold tax reliefs which are given against national tax.

Option F: A wholly free-standing local income tax
This approach has all the local features of Option E. In addition, local authorities are free to set their own tax base, tax allowances, and rate schedule, independently of the national tax system.

The series of options from A to F above follows a broadly logical progression, with each step building on the step before, and adding a new element of local autonomy or complexity. It would, of course, be possible to structure a different sequence of options with a different mix of features. On the whole, however, it seems less plausible that a government, concerned with value for money, would, for example, wish to face the relatively complex business of giving local authorities freedom to vary the tax base, but deny them the simpler freedom to vary the tax rate; or that a government would require employers and taxpayers to submit separate tax returns to local authorities, but require local authorities to charge a uniform surcharge on the national tax base, akin to an hypothecated income tax.

Within each set of options there is, of course, a range of variants. For example, Options B and following give local authorities freedom to set the rate of tax. This freedom (especially under the earlier options) might well be restricted to one rate of tax for each authority (xp, yp, zp, etc. in the £; or alternatively - and with a rather more progressive effect - x per cent, y per cent, z per cent, etc. of the national income tax charge) applying to all taxable income of

a local resident; or it might (possibly under Option F) allow local authorities to charge progressive (higher) rates of tax on larger incomes, in addition to the progressive national tax schedule. As another example, the freedom to depart from the national tax base in Option F might be relatively restricted (for example, to give a higher or a lower personal allowance), or much broader (for example, to provide for new local forms of child care, or for local investment incentives).

Notes

1 Layfield Committee, Report on Local Government Finance, 1976; Cmnd. 6453.

CHAPTER 2

THE NATIONAL TAX SYSTEM

TO JUDGE HOW a local income tax might work, one needs to understand how the national income tax works in the UK, the ways in which it differs from the tax system of many other countries which already have a local income tax, and the ways in which it might develop over the years ahead. The present is important, because it is where we have to start. But - with due respect to Benjamin Franklin - the only certain thing about the future is that it will continue to change.[1] And it is important to try to judge the direction of change, and how any future developments could affect the options for a local tax.

As The Tax System Is Now

The taxpaying population

Summary figures for 1990-91 show 25.7 million taxpayers[2] paying £55.3bn income tax; and the income tax system costing some 50,800 staff in the Inland Revenue to administer.[3]

Income tax from different sources is charged under a series of Schedules:

- Schedule A: rent and other receipts from land and buildings;

- Schedule B (now obsolescent): income from the occupation or use of woodlands managed on commercial bases;

- Schedule C: interest on certain British government securities and securities of foreign governments and public authorities;

- Schedule D:
  Case I, profits of trade
  Case II, profits of profession or vocation not dealt with under any other schedule
  Case III, interest and annual payments paid without deduction of tax

Cases IV and V, all income, other than employment income, arising abroad whether or not remitted to the United Kingdom

Case VI, any other income, in particular income from furnished lettings and occasional profits not chargeable under Cases I and II

- Schedule E: Income from office, employments and pensions;
- Schedule F: company distributions.

For obvious practical reasons, all countries have conventions for identifying different types of income, and for applying appropriate tax rules to them. The precise details of the UK schedular system are, however, largely historical. In practice, far the most important schedules are now Schedules D (together with the minor Schedules A and B, yielding around 11 per cent of gross income tax receipts) and above all E (yielding about 72 per cent).

It is now unusual for a taxpayer to have only one source of income - such as a wage or salary. Some 80 per cent of all taxpayers have two or more sources of income. The most common second source of income is, of course, from investments. For example, some 35 million people - of whom some 20 million may be taxpayers - now receive interest from 100 million or so bank and building society deposits (compared with, perhaps, 10 million people in 1976). In addition:

- Of people whose main source is income under Schedule E (primarily employment or pension) some 2 million people (typically pensioners and agency workers) have more than one Schedule E source; there are some half a million directors; and over a quarter of a million people earn a second income taxed under Schedule D (self-employment etc).
- Of people whose main source is income taxed under Schedule D (primarily self-employment) between a quarter and half a million people also have a source of income under Schedule E.

Three recent developments have combined to add an important new category of people who are not, or should not be, taxpayers but who are or may be involved with the tax administration. These are:

• Independent taxation: since 1990, a married woman has been treated as independent for tax purposes, her investment income is no longer aggregated with her husband's and taxed at his marginal rate; and if below the tax threshold, she is entitled to claim repayment of any tax deducted from interest or payment of tax credit on any UK dividends.

• The abolition of composite rate tax on bank and building society interest; so that someone whose income is below the tax threshold is entitled to register to receive interest gross, or to claim repayment of any tax that has been deducted.

• The increase in the number of small equity shareholders, following the government's encouragement of wider share ownership, successive privatisation issues and the conversion of the Abbey National Building Society into a public company.

As a result, by 1991-92 there were up to 15 million or so people below the tax threshold (mainly pensioners, married women and children) in receipt of investment income, which could be charged to income tax or advance corporation tax (ACT). Very many of them could register, and have registered, to receive interest without deduction of tax. Experience over the next few months may well show that many others, for one reason or another, will not in practice claim the tax benefits to which they are entitled. As against that, the 1992-93 Budget Statement introduced a fourth new development:

• A reduced rate band of £2,000, with the result that 20 per cent will be the marginal rate of tax for some 4 million people, and many of these will be entitled to claim repayment of basic rate tax of 25 per cent deducted from investment income.

Thus, over the last two or three years or so there have come into the tax system many millions of low-income people who are entitled

to - and many may reasonably be expected to - send in simple tax returns and claim repayment of tax or payment of tax credit.

In brief, out of a total UK population of around 57 million (including infants and children), approaching 26 million people are liable to tax. Up to another 15 million people have investment income which may be taxed at source. Five million or so employees (including some of the 15 million above) are within PAYE but not liable to tax for the year as a whole.

Employment income

Tax under Schedule E (employees and pensioners) accounted in 1990-91 for some 72 per cent of all income tax receipts and 79 per cent of all taxpayers were chargeable under Schedule E.

Just under 99 per cent of all Schedule E tax was deducted at source under the PAYE (pay as you earn) system. This was the responsibility of some 1.3 million employers. Over three-quarters of the yield was the responsibility of a small number of large employers (2 per cent of the total). A large number of small employers (more than a quarter of the total) were responsible for barely 1 per cent of the total yield.

Virtually all developed countries have some form of withholding tax on employment income:

- It is much cheaper to collect tax from, say, 1 million or so employers, than from 20 million or so employees.

- It has cash-flow advantages for governments - and also runs with the grain of modern payment arrangements in so far as it provides for payment to be spread over the year.

- It is much more secure against evasion, except in the special case of collusion between employer and employee.

The form of the UK system, however, is unusual in seeking to collect - and generally succeeding in collecting - the right amount of tax from employees from week to week, and month to month during the year, so that the employee ends the year with no back tax to pay or tax repayment to claim. The Irish PAYE system is similar. The Japanese PAYE system also aims to finish the year for

the vast majority of employees, having deducted the correct amount of tax for the year as a whole (though this is achieved by an adjustment towards the end of the year, rather than by a weekly or monthly adjustment during the year).

Most other countries, however, including the United States, aim for a more or less broad-brush deduction during the year, on the basis that taxpayers will submit a tax return after the year-end, and then either pay any tax owing or (commonly) claim back any tax overpaid.

PAYE in the United Kingdom uses both structural and administrative devices to achieve its results.

The tax structure has a long band of income subject to a single basic rate (in 1992-93 25 per cent). At 1992-93 levels someone could have taxable income (after all reliefs and allowances) of up to £23,700 a year, before becoming liable to higher rate tax (in 1992-93 40 per cent). In practice, in 1990-91 (the latest year for which the detailed out-turn is available) 25 per cent was the marginal rate of tax for some 24 million people, including 20 million employees (over three-quarters of all employees in PAYE,[4] and nearly 95 per cent of all employees liable to tax). Around one and a half million people, including a little under one and a quarter million employees, were liable to higher rate tax. In 1992-93 the new reduced rate band, with a marginal rate of 20 per cent for some 4 million taxpayers, will modify this pattern; and (though the precise outcome will depend on movements in earnings and employment over the rest of the year) the 25 per cent basic rate may be the marginal rate for something nearer 80 per cent than 95 per cent of employees; but the broad picture will remain.

The administrative arrangements under PAYE rely on a sophisticated system of coding, coupled with the deduction of tax on a cumulative basis through the year:

- The taxpayer's code will not only reflect the taxpayer's personal allowances (single, married, aged, etc.). It may also reflect other reliefs to which he or she may be entitled (such as professional or trade union subscriptions) and it may take into account other income, which has not been taxed at source (such as National Insurance benefits and benefits in kind). It may provide for the

collection of any tax underpaid for the previous year. And the code in certain cases may be reduced to protect the Exchequer, where a tax return has been requested, but not submitted. There are 50 or so possible codes - some of them pretty rare - which may be revised in the course of an Annual Review, or at Budget time, or at any time during the year. A little over half of all employees at any time are likely to have one factor in their codes, and over one-third 2 or more factors.

• The cumulative system of tax deduction means that, at every pay day, the employer takes account of all wages and salaries paid up to that date in the financial year, all tax deducted up to that date and a due proportion (up to that date) of all reliefs and allowances for the year as a whole. With the help of the correct code, therefore, the taxpayer will (in a very simple example) have the correct benefit of one-quarter of the full-year reliefs to which he or she is entitled by the end of the first quarter of the year, one-third by the end of the first four months, and so forth - and any interim over- or under-payments will have been put right in the course of the normal weekly or monthly cumulative calculations.

• The employer receives authority from the Revenue to apply a particular code to a particular employee. In the case of many across-the-board changes (particularly at the annual and budgetary reviews, and for employers with computer-assisted pay rolls), and following computerisation of the Revenue's own PAYE system, codes can be changed relatively quickly and cheaply, but the process remains expensive where the code needs to be changed because of new information, such as a new claim from the taxpayer.

• To support these arrangements - and help to maintain the cumulative 'thread' - the Inland Revenue's own PAYE arrangements are largely employer-based. The tax records for an employee (and the relevant file, if there is one) will normally be held in the tax office dealing with other employees of the same employer. If the employee moves from one employer to another, his or her records will commonly move accordingly (the number of 'movements' in any year may be in the region of 40 per cent of all employee

records, but this includes a number of employees moving more than once in a year; and the number of people changing jobs in any year may be nearer one-third). The arrangements in Scotland are different.

Other administrative arrangements support this system:

- Income tax is deducted at the basic rate from most common forms of interest (automatically satisfying the marginal tax liability of the vast majority of employees without any need for an individual return).

- ACT is charged on dividends from UK companies (enabling the tax credit to achieve a similar result).

- On a number of major tax allowances (personal pensions, mortgage interest, charitable covenants, gift-aid, private medical insurance, vocational training) relief is given by deduction of basic rate tax at source. Thus, again, the vast majority get relief at basic rate automatically, without need for an individual claim.

- On certain tax incentives (PEPs, TESSA) the mechanics of relief are essentially devolved to financial institutions - in a sense 'privatised' - again avoiding the need for the individual to submit a claim to the Revenue.

As a result of all this, six out of seven employees do not need, and are not asked to submit annual individual returns of their income. Annual tax returns are needed only for the minority of people with more complex affairs - such as many higher rate taxpayers and directors. Some others (for example, with multiple sources of income) may be asked to send in a tax return from time to time. For the rest PAYE ends the year having deducted the right amount of tax, or so nearly the right amount that the Revenue has no need to trouble the taxpayer to send in a return, to demand additional tax or to repay it. For these people PAYE is neither 'Revenue assessment' nor 'self-assessment': it is a 'non-assessment' system.

Self-employment

The UK system for taxing income from self-employment (Schedule D) has a number of features familiar in other tax systems. The taxpayer is required to submit a return of his income. The Inland Revenue is required to satisfy itself that the return is correct and, if so, assess it to tax accordingly. In 1988-89 there were a little under three and a half million people with income from self-employment (Schedules D, Cases I and II).

Here also there are some special features in the statutory regime that may be relevant for a local income tax. The tax liability is assessed on an artificial 'preceding year' basis, with complex opening and closing adjustments. As a result, the self-employed man's liability for a financial year will not often bear any direct relationship to his income in that year. Indeed, it will only be by accident if his taxable income over his business lifetime is the same as his actual income over that period. If he has multiple sources of income, his tax liability for a year may well be assessed to two or three quite different periods of time. Associated with the complexity of the statutory basis for tax, the arrangements for encouraging taxpayers and their agents to submit tax returns and accounts and for assessment are time-consuming and inefficient, earning the adjective 'Neanderthal' from the Keith Committee.[5] The government in 1991 authorised the Revenue to issue a consultative document[6] with proposals for legislative reform to simplify these arrangements. Consultations were still continuing at the time of writing.

Other income

The importance of the widespread arrangements for deduction of tax from investment income at basic rate, being the marginal rate for most taxpayers, has already been noted above.

Summary of present position

The result of these arrangements is that the Inland Revenue in the UK does not now have a number of capabilities which other countries have, when they run a local income tax:

- The Revenue does not need, and therefore does not have figures

of total income for many employees.[7]

• The Revenue does not need, and therefore does not have, up-to-date and reliable information about many taxpayers' places of residence.

• A taxpayer with multiple sources of income (for example, a pension, a consultancy and a couple of directorships) may have different streams of income dealt with by different tax offices up and down the country.

• Individual tax liability for any financial year may relate to a variety of quite different calendar periods - during which the taxpayer may have moved from one local authority area to another.

It was presumably this combination of features which persuaded Revenue witnesses to the Layfield Committee to say that, if one wanted to arrive at a local income tax, one would not choose to start from here.

As The Tax System May Possibly Develop

In successive reports - starting with the 'Direction of Change' and developed thereafter in their management plans and Annual Reports[8] - as well as a variety of consultative documents over the following 7 years - the Board of Inland Revenue has published material about the general direction in which the tax administration has been developing recently.

Taxation of self-employed
If the proposals on the taxation of the self-employed bear fruit, they could open up significant new possibilities for both UK tax administration and policy:

• Their immediate objective would be to simplify the rules for taxing income from self-employment and streamline the administration - in particular, by moving from a 'preceding year' to a 'current year' basis of assessment - (as a rule of thumb, tax under

Schedule D tends to cost about three and a half times as much to collect as tax under Schedule E). The aim would be to spend less time cranking by hand the cogs of the Schedule D machinery, to make it easier for self-employed taxpayers to manage their own tax affairs, and to free more official resources for customer service and compliance.

• Looking further ahead, they could open up a new possibility of - or at least remove a major road block to - total income assessing in the UK: the possibility of being able to set down in a single calculation on one piece of paper, a taxpayer's total taxable income for a given calendar period, and tax liability for that period.

Some aspects of these changes will perhaps have been pioneered by the corporate sector, most recently with the new 'Pay and File' arrangements due to start in 1993.

Bank and building society interest; and reduced rate band

We have already mentioned the new arrangements for taxing bank and building society interest which came into force in April 1991, and the possibility that, one way or another, they may bring into contact with the tax administration up to 15 million potential new customers; and also the new marginal rate in 1992-93 of 20 per cent for 4 million low-income taxpayers. It is a curious thought that the Revenue may quite possibly shortly find itself receiving more returns from non-taxpayers than from taxpayers. To handle this new - high volume, low value - business the Revenue is needing to experiment with and possibly develop a number of skills and capabilities that might well be valuable in handling a wider return issue generally:

• To capture third-party information (potentially up to 100 million items) electronically from the payers of income among the big financial institutions.

• To match information from taxpayers themselves and from third parties (the payers of income) with a taxpayer's computer record with a minimum of (expensive) clerical intervention.

• To explore the operational value of a more reliable record of taxpayers' addresses.

Schedule E

Similar themes could also be relevant for the present PAYE. For example, the arrangements by which an employee's tax records are held by the employer's tax office do not make it easy for the Revenue to get, or to give the taxpayer, a view of the overall tax position, when he or she has more than one employment or other source of income. The thing has to be done - and is done - when, for example, someone has a higher rate tax liability. However, the present arrangements still reflect something of the historical origins of the schedular system, when the tax authorities, though they needed to know the amount of each source of income, did not need to know, and were not intended to know, the total amount of any individual's income. To improve customer service and efficiency generally, the Revenue could find it helpful to develop ways of bringing all the necessary information together more conveniently in one place, when it needs to communicate with taxpayers or respond to them. In principle, this could mean either or both reducing the cost and increasing the speed of communications between different tax offices dealing with the same taxpayer, or handling all a taxpayer's affairs within a single tax office (perhaps, though not necessarily, related to place of residence). Indeed, on the face of it, this could be a precondition of any move towards total income assessing.

These various developments in hand or in prospect are within the ambit of present tax policy (though some would require new legislation); and they stand or fall on that basis. To the extent that they have common themes of reducing the costs of routine processing of bulk information returns, and making it easier to bring together information about the taxpayer's address, total income and the tax due on that, they could also be consistent with any new policy that required a wider issue of tax returns, or a need for the Revenue to know more taxpayers' addresses or total incomes.

Possible new developments for PAYE

The present PAYE arrangements have considerable strengths. They bring in over £50bn of revenue, for the most part efficiently and securely. They ensure that the vast majority of individual taxpayers are not directly troubled to submit a tax return, or pay tax direct to the Revenue. Within the last few years they have successfully adapted - at great speed - to big changes to the taxation of husband and wife, and to bank and building society interest.

At the same time they have been criticised on two main grounds. First, they are expensive for the Inland Revenue to run. International comparisons are always tricky, and to be used with caution. However, if, for example, the UK PAYE is compared with its United States equivalent, the best estimate probably remains that of Professor Sandford in 1989.[9] The total cost of the two systems may be proportionately much the same. Within that total:

- The Inland Revenue's costs are perhaps two or three times those of the Internal Revenue Service (IRS).

- By a similarly striking contrast with the US practice, Sandford estimated that 2 out of 5 UK taxpayers (and 4 out of 5 taxpayers' wives - admittedly in the days before independent taxation) spent no time at all on their tax affairs.

In brief, the UK Revenue was doing in the UK much work that taxpayers and their agents did in the United States. In a similar comparison of total operating costs of the tax and social security contribution arrangements in the UK and Canada, Professor Sandford found a similar contrast, with lower official costs in Canada more than balanced by higher compliance costs for taxpayers and employers.

It is of course very much a matter for political choice, how the costs of a tax system should be shared between the public and private sectors: and similarly how far employees' responsibility for their own tax affairs should be eased so far as possible, or (on the contrary) made more perceptible. And, as emerged very clearly in both official and private sector evidence to the Layfield Committee, it would be the most elementary of mistakes, to look at the public

sector costs in isolation from the private sector costs. However, if under any government the political priority were to be to minimise the Revenue's in-house costs, and to maximise taxpayers' awareness of and responsibility for their tax liabilities, this could shift the balance of advantage towards something closer to the arrangements in other countries with a much wider issue of personal tax returns.

A second group of criticisms turns on the fact that the UK PAYE does not adapt easily to certain kinds of possible new policy options, which some commentators have advocated. It puts great effort into ensuring so far as possible that employers have the right code for each employee and that the cumulative 'thread' is maintained, so that the employee will end the year having paid the right amount of tax. Well over half of tax offices' time in running PAYE is spent on 'in-year' work of this kind, and one-third on 'in-year' daily coding and movements of employees between employers. Any new tax policy that required a large amount of new end-year work on top of all that - for example, to handle many more personal tax returns - could make the system not only very expensive, but also very cost-ineffective, as more and more taxpayers needed to have their affairs handled two or three times in a single year. Thus, there are constraints on any policy that:

- Effectively breaks up the long basic rate band, in such a way that the tax deducted at source from investment income, or from secondary PAYE jobs, or ACT, ceases to reflect the marginal tax rate for the great majority of employees; or

- Similarly uses the tax system to claw back (for example, as in Canada) child or other social security benefits on a broadly progressive income scale; or

- Gives a new tax relief of a kind that requires a high proportion of ordinary taxpayers to submit annual tax returns or claims (examples could include a system of transferable allowances between husband and wife, or a claim for relief on the first £x of an individual's investment income, or for various detailed items of expenditure).

Again, it is for political decision, whether policy options of this

kind are or are not desirable. If they were desired, they could again shift the balance of advantage - not necessarily decisively in the case of any single proposal - but more or less forcefully, depending on what precisely was proposed, and how that fitted in with other demands on the tax system - towards PAYE arrangements closer to the arrangements in other countries, which turn on receiving large numbers of personal tax returns and establishing a taxpayer's total income.

In conclusion, some current developments seem likely to involve the Inland Revenue in new capabilities of a kind that other countries find relevant in running a local income tax. Some possible new policy options, if a future government were to be attracted by them, could shift the balance of advantage towards a system with many more tax returns and more information about taxpayers' total incomes, which again other countries find relevant in running local income taxes. But it remains a fact that these are not yet either requirements or capabilities of the present system.

Notes

1 "In this world nothing can be said to be certain, except death and taxes". Franklin; letter to Jean-Baptiste Le Roy, 1789.

2 Inland Revenue Statistics 1991. From 1990-91 a husband and a wife are counted as two taxpayers, with the advent of independent taxation.

3 Board of Inland Revenue, Annual Report for the year ending 31 March 1991.

4 In 1990-91 there were some 27 1/4 million employees (including people receiving unemployment benefit) within PAYE; of these about 5 1/2 million people were not liable to PAYE tax.

5 Keith Committee: Enforcement Powers of the Revenue Departments 1983. Cmnd 8822.

6 *A Simpler System for Taxing the Self-employed*, Inland Revenue, 1991.

7 The Revenue does receive end-year returns of employment income from employers (and also end-year returns of certain types of investment income from some financial institutions). These can be valuable for monitoring purposes. In a number of respects, however, involving both time and coverage, they would in present circumstances provide a significantly fallible basis on which to charge a local tax on total employment (or other) incomes generally.

8 *The Direction of Change*, Board of Inland Revenue, 1985; successive Annual Reports of the Board and annual Management Plans; and, most recently, *The New Inland Revenue, an Overview of the Management and Grading and Organisation and Structure Reviews*, Board of Inland Revenue, 1992.

9 *Administrative and Compliance Costs of Taxation*, Professor C.T. Sandford *et al.* Fiscal Publications, 1989.

CHAPTER 3

THE CRITERIA

EARLIER DISCUSSIONS have tended to focus on seven main criteria by which a local income tax can be judged.

Two Fundamental Criteria

Local responsibility/power of decision

The first of two fundamental questions is whether the local authority has power to decide how much tax to charge and, if so, within what (if any) limits.

If local authorities have a genuine freedom to set a rate of tax, a local income tax can deliver one of its classical objectives. That is, to give local authorities not only a wider tax base, but also a wider freedom to spend or not to spend, and a corresponding responsibility for financing optional expenditure.

On the face of it, it seems possible that, if both central and local government are taxing incomes, there may be some conflict of interests, if not competition between them. In some countries there are rules to regulate any such conflict:

- For example, in some countries central government may retain power to approve local income tax rates (for example, Belgium), just as local authorities, if one may describe in those words the States or Provinces in a Federal constitution, themselves may commonly retain power to approve the rates of any taxing power that they give to subordinate authorities (USA).

- In some countries central government gives local authorities freedom to set a local income tax rate up to a prescribed level or 'cap', but not beyond that without specific approval (Japan and, at least temporarily, Sweden).

- In some countries the local authorities may have freedom to set any tax rate they choose, but the legislation places a limit on the

overall rate of tax that can apply to any individual's income (as in Sweden before the 1991 tax reforms and Denmark). In those cases the central government tax is in effect the marginal tax.

• Central and local government may tax different tranches of income (as in Sweden following the 1991 reforms).

In other countries again, local authorities have absolute freedom to tax, and it is left to the political market place to ensure that the cumulative national and local tax take is not intolerable (USA and Canada). In Canada for example it is said that, in the context of a new settlement with the Provinces in 1962, the Federal government abated its take 'to allow tax room' for the provincial income taxes.

At one extreme, if the central government fixes the rate of tax, or sets a limit or 'cap' so low that virtually every authority has to charge the maximum - we have at least one of the main features of an hypothecated income tax.

At the other extreme in some countries the state or provincial authorities have a constitutional right, not only to fix a simple rate of tax, but also to fix their own (independent of central government) tax thresholds, more or less progressive tax schedules, and tax reliefs and allowances. In effect, they are free to use income tax not only to raise finance, but also to further their own political, social or economic objectives.

Local accountability/perceptibility to taxpayer

The second fundamental question is, if you like, the local taxpayer's view of the first. How clearly does the local taxpayer perceive the local authority's responsibility for taxing his income? How far does this perception make the local authority more accountable for its spending and taxing decisions?

Under any local income tax option there is scope for imaginative presentation and publicity. Deductions from the pay slip and tax assessments can be itemised clearly to distinguish national and local elements. Explanatory leaflets can be enclosed with assessments or posted through letter boxes, Ministers and Local Councillors may make speeches and so forth.

However, there may for this purpose be significant differences in

the structure of the different options. For example, it may be felt that people will less easily perceive the 'local' nature of a tax that is assessed and collected wholly by the national Revenue, as part and parcel of the normal collection of the national income tax. The Layfield Committee in its Report in 1976, which still remains a starting point for the debate on local income taxes in this country, argued at one point that "accountability ... should be based on local taxes paid directly by local electors".

Thus, more people may hold the local authority more accountable, to the extent that they perceive it as directly involved in the tax process. There are overseas precedents for central government to administer the local tax (Belgium), for local authorities to administer tax before ever it became a national responsibility (Switzerland), for wholly separate and independent national and local tax administrations (USA) and for different patterns between central and local administrations even within a single state (Canada).

Other Criteria

Speed of introduction

Any radical change in administrative arrangements will need some time to implement, even though IT and other systems are being increasingly designed to accommodate change, so far as that can be done at an affordable price. In brief, change requires an investment of time as well as money. The nature of politics, not to mention the five-year maximum term of any parliament, tends to discount changes with a long lead time.

Of the six options in Chapter 1, only a hypothecated income tax could be implemented with broadly the Inland Revenue's present information and systems.

It was estimated at the time that Option B (the 'Layfield' option) would require something like five years to implement from the time of the legislation, "five years or more" overall. The precise timetable in present circumstances would depend on the precise details of the new system and the priority (including the priority for the necessary investment) that it was given by the government of the day. Meanwhile, though there is no basis on which to suggest any

alternative to the Layfield "five years", the recent record is one of relatively fast adaptation of the Revenue's administrative systems to new policy demands.

At the time of the Layfield report PAYE was in the process of computerisation. That complicated the then time-table. The PAYE computer system went live in 1987. Since then it has been much enhanced: and like any IT system, both hardware and software will undoubtedly continue to need to be replaced and modernised from time to time.

Starting from where we are now, the implementation of any radically new income tax would need time to complete some or all of the activities necessary:

- To consult with local authorities, employers etc;

- To prepare legislation, and see it through Parliament (followed by any necessary subordinate legislation, or regulations);

- To work out and set in place processes to acquire the necessary information about taxpayers' residence, income or whatever;

- Actually to get that information from taxpayers or payers of income;

- To set in place processes for handling and sorting that information and communicating it between Inland Revenue, employers, payers of income and local authorities (as necessary);

- For local authorities (in some options) to put themselves in a position to issue assessments and demands for tax to their local taxpayers, plus (in further options) to handle taxpayers' returns, claims to relief etc;

- For employers (in some options) to acquire the ability to deduct tax at different rates from employees resident in different areas;

- For each player in the business to test each process rigorously, before the system went live.

Each of these processes would undoubtedly need significant new IT support, whether hardware or software, as well as recruitment, training and accommodation of the necessary staff. But that is true nowadays of almost any new major administrative task. The IT implications are part of the time-table of any major change - rather than a separate and additional constraint.

Cost of administration

Any major change has a frictional price, as all the players (central and local government, employers etc., taxpayers) have to learn the rules of the new game. Especially at present, some local authorities are still absorbing the effects of the changes from Rates to Community Charge, and from Community Charge to Council Tax, and are, perhaps, a little bruised by the experience. There is a power (though not an absolute power) in the adage about an old tax being a good tax.

Frictional costs aside, the different options have very different administrative implications and the need is to balance costs against effectiveness. Of the six options:

- Only the hypothecated income tax requires little significant change in present procedures, and relatively little extra administrative cost.

- The Layfield scheme sought to minimise the cost of the local element, but the costs of the local tax were still significant, and all effectively additional to the cost of the (already expensive) national tax.

- Other options could be much more expensive again, combined with the present national system. But the balance could change, if the national tax system itself were to change.

That said, a local income tax must add something to the costs of collecting income tax overall.

In this analysis employers' costs weigh alongside the authorities' costs. The Revenue's costs of collecting income tax average a little over 2 per cent overall, and its costs in operating PAYE approach

1 per cent. The best available estimate is probably that the private sector's, mainly employers', costs are of a similar order of magnitude.

Confidentiality

The UK legislation makes the Board of Inland Revenue responsible for the care and management of the income tax, and prescribes strict rules of confidentiality for Revenue officials (with criminal sanctions for any breach). Except in a few special cases explicitly provided by Statute - for example, in compliance with a Court Order in a drug prosecution - people outside the Revenue - including Ministers - do not have access to information about a taxpayer's affairs without his or her prior consent. What is involved in confidentiality? What should be the rules for any exchange of information between the Inland Revenue and the local authorities for a local income tax? Would this be likely to pose problems?

What is involved?

In terms of sensitivity there are probably four main bundles of information which the Revenue might have, relevant to one or more of the local income tax options:

• About a taxpayer's address (many people are happy to be in the telephone book: but not everyone wants people to be able to find them easily);

• About the size of someone's total taxable income (public salaries are public knowledge, but some in the private sector are sensitive about how much or how little they earn. And there could, for example, be speculative comment, if it became known that a public figure enjoyed a taxable income much larger or - perhaps more intriguing - much smaller than one might have expected. A businessman could gain a competitive advantage if he got private knowledge that a competitor, or business partner was trading unprofitably);

• About the details making up someone's taxable income. This could include details of:

the source of each slice of income (sensitive areas could include the

type of employment, business or investment, or the country in which a taxpayer's wealth is invested);

the internal costs or, less probably, the business processes of a trade competitor;

personal or family circumstances: again, there is generally no problem. In some cases, however, there could be sensitivity if it were known that a taxpayer is (or is not) married, or is (or is not) paying alimony;

tax reliefs claimed: for example, where someone did not wish it to be generally known that he had legally reduced a large gross income to a much smaller taxable income by the creative use of various tax shelters;

- About compliance: for example, where someone had been guilty of fraud or negligence in his tax affairs and in consequence was liable to pay substantial back duty and penalties to both the central and the local tax authorities.

Exchange of information

The case in principle for confidentiality is simple. People who are required by statute to disclose information about their private affairs have a right to expect that information will not be used for any purpose, other than that which Parliament explicitly legislated. And in practice a risk has been perceived that people will be less willing to provide the information needed to establish their correct tax liability, if they are not confident that it will be kept private.

That said, the natural expectation might be that, if the Revenue had information which a local authority needed to establish a taxpayer's local tax liability, there should be no statutory bar to the Revenue exchanging information accordingly. We are concerned here with essentially the same information, for effectively the same purpose; and it would perhaps merely add to public and private sector costs, if the legislation were to require the taxpayer always to provide it twice, and for tax authorities never to cross-check. Overseas legislation commonly permits exchange of information for this kind of purpose, even where the local tax authority may require

a separate tax return for local purposes; and some legislations explicitly exempt a taxpayer from making a local tax return, if he has made a return to his national tax authority.

Position of local authorities

It may be felt that exchange of tax information with local authorities raises no new issues of confidentiality. Local authorities already get much information direct from their local citizens on their financial affairs for housing benefit and student grants; and they are well used to the need to safeguard its confidentiality. Overseas local authorities get information over the whole range of taxpayers.

Anxiety has been expressed in previous discussions that:

- There is more risk of improper use of information, for 'voyeurism' or other reasons, at the higher income levels.

- Smaller local authorities might find it difficult to maintain - if that is thought desirable - the same confidentiality barriers between official and elected representatives.

- It would be more likely within a local authority area for elected representatives (if it were decided that they should have a part in the tax administration) to be concerned with information about a political opponent or business competitor.

As against that, it would presumably be possible to legislate, if that were wished, the same kind of safeguards, and criminal penalties for any breach, as now exist for the national tax.

The choice here would be for political judgement. Broadly, between the six main options:

- Options A - C (local income taxes administered by the Inland Revenue) imply little or no new information for local authorities about individuals' financial affairs;

- Option D (a local income tax administered by local authorities,

on the basis of information about total income reported to them by the Inland Revenue) implies local authority access to people's addresses and total incomes - but not details of their personal affairs;

• Options E and F (local income taxes wholly administered by local authorities) imply full local authority access to the range of data now available to the Inland Revenue.

In-year collection

Some of the earlier discussions put much weight on the ability of local authorities to collect in the year the tax that they wish to charge for that year - and the disadvantages of a significant lag between the date of liability and the date of collection.

This is not an issue in an hypothecated tax. Central and local government can negotiate together an acceptable schedule of payments from one to the other. Neither is it an issue with the Layfield variant (Option B). Certainly, there are substantial lags in the Layfield system, but there is no structural link between the payment of tax by any individual and the receipt of cash by any local authority. For purposes of local authority cash flow the position seems close to that under an hypothecated tax.

For the other variants:

• There is on the face of it no over-riding reason why payment of local tax on self-employment income should not follow the national pattern. This is one of the areas put out for discussion in the current consultative document (see Chapter 2). To the extent that payment continued to lag behind the period of liability, this would need to be one factor to be taken into account in the transition from grant to local tax.

• For employment income there could be a choice (see particularly the discussion in Chapter 10) between continued deduction at source, or end-year payment, or provisional in-year payment with an end-year settlement. Most overseas local taxes provide for some deduction at source - either by reference to current income or (for example, in Japan) by reference to the previous year's income.

The buoyancy of income tax necessarily means that, just as the yield rises when incomes are rising, so it increases more slowly, if it does not actually fall, when the economy is depressed. The margin of error between forecast and out-turn is not of an order to raise questions about its value for national revenue purposes. It may, however, be relevant to the question whether a local income tax is best seen as the only, or as an additional source of local revenue.

Flexibility

Income tax yields big money, with each 1p yielding some £2.5bn in a full year. The Layfield Committee, in particular, heard anxiety that local authorities might not want to, and in practice should not always, set local income tax rates to the nearest whole 1p, or to move only in steps of even ½p or ¼p. They contrasted the flexibility of the rating system, in which rates could be set to up to two decimal places.

The constraints are of two kinds. Within the national tax system they are essentially of cost-effectiveness and simplicity for government and for employers. Undoubtedly, it would be possible to charge income tax at a fraction of 1p. However, there would be a cost, as employers revised their computer programmes and forms to make room for one or more decimals; and the continuing cost could be particularly troublesome for the large numbers of small employers without IT support for their payrolls. On balance, it has been felt that the national financial system is sufficiently sophisticated, not to need this complication, and not to make it cost-effective.

Fractions of 1p in a local income tax could add special problems. Within any range of rates, it would obviously multiply the possible options: up to 10 times, if local authorities could go down to one decimal place; up to 100 times at two decimals. Employers, and again in particular small employers without IT support, could under certain options be required to operate a formidable number of tax tables as their employees travelled in to work from different local authority areas. The Layfield Committee suspected that, if the administrative burden, on top of the present sophisticated PAYE were not to be unmanageable, it would be necessary to restrict both the number of local authorities entitled to charge local income tax

and the range of possible tax rates.

IT support has of course increased greatly since Layfield, and reliable payroll software has (with Revenue support) become much more widely available. But the general pattern remains. Though precise figures are not available, it probably helps to indicate the pattern, though probably exaggerating it, to look at the proportion of employers who now make their end-year returns to the authorities on magnetic tape:

- Virtually all the one hundred or more employers with over 30,000 employees make returns on magnetic tape.

- Barely one-quarter of one per cent of the nearly one million employers with 20 or fewer employees submit end-year returns on magnetic tape (though many of them no doubt use some less sophisticated form of IT support).

Overall, perhaps a quarter of employers may have their own computer, or bureau support for their payrolls.

The practical problems of a fractional rate do not seem to arise in the same degree with a system relying on end-year assessment. The arithmetic is done within the authorities' computers, and the taxpayers' concern is more with the size of their tax bills than with the mechanics of the calculation. The government White Paper of 1981[1] envisaged that, under an end-year tax system, it would become administratively practical for local income tax to be charged down to the level of the 450 or so (then) lower-tier authorities.

Thus, for example, in the United States, a local school board seems free, within the limits set by its state government, to set a tax rate of 0.6179 per cent.[2]

Notes

1 Alternatives to Domestic Rates, Cmnd. 8449. 1981.

2 Portland, Oregon.

CHAPTER 4

RESIDENCE

UNDER ANY local income tax (other than an hypothecated tax) there need to be rules, identifying who is liable for local income tax and what income each local authority is entitled to tax.

Liability

As the earlier literature emphasises, 'residence' can at the margin be a complex question, with much case law to guide it, and a variety of Double Tax Treaties to constrain it. One possibly attractive suggestion in earlier discussions[1] was that 'residence' for local income tax should follow on from the determination of 'residence' for the national tax. If someone is non-resident for national tax, then he or she cannot be resident for local tax in any local authority; if resident for national tax, he or she must be resident for local income tax somewhere. It is 'simply' a question of determining in which local area liability will arise. In principle, problems of 'double taxation'[2] and the 'nowhere resident' should not arise, where they do not already arise and need to be resolved, for national tax purposes.

A similar rule might apply, with similar results, in certain special cases, for example:

- Where the UK exercises rights to tax income of a permanent establishment situated in this country, but owned by someone resident abroad;

- Where the UK does not tax the world-wide income of someone who is resident here (perhaps because of relief for income taxed overseas, or under the special remittance basis for people resident but not domiciled here).

Resident where?

Within that broad approach, the choices, in principle, are:

- The residence of the taxpayer;

- The source from which the income is derived;

- A mixture of the two.

In practice, the previous UK studies have been pretty much in agreement that residence as a rule is the simpler and more straightforward basis. That is also as a rule the basis for local income taxes in other countries. It remains a reasonable working assumption that any local income tax in the UK would at least primarily be charged on the income of people 'resident' in the area of the local authority. But there could be occasion - and there are overseas precedents - for alternatively taxing business income in the area where a permanent establishment is located, in the special case where the owner of the business is not resident in the UK.

Resident when?

The choice here is between:

- Fixing residence for a year by reference to a single point in time;

- Looking for a more precise allocation of responsibility, according to the precise period for which a taxpayer is resident in each local authority area.

In practice, most countries deem a taxpayer to be resident in a particular area, if he or she is resident there at a particular statutory date. In some cases (for example, Canada) this is the last day of the year; in others (for example, Japan) it is the first day. The Layfield Committee (because of the particular nature of the tax system that they envisaged) had in mind a date some months before the beginning of the financial year. There are instances, however, where local authorities (for example, in the United States) are prepared to apportion periods of residence within a year, so that a taxpayer moving from State A to State B is liable to income tax in State A for the months up to his departure and in State B for the months after his arrival. The trade-off is between simplicity, but a degree of

rough justice, with a fixed statutory date; or alternatively the significantly greater complexity of a more precise adjustment after the year-end. The number of changes of address that are relevant for the purposes of a local income tax would depend very much on the size of the local authority authorised to charge the tax: on anything approaching Layfield's assumptions, however, leading to some 2 million relevant changes of address, there would be strong practical arguments for choosing the simpler option.

Emigrants and immigrants

For people moving into and out of the UK one could apply the 'statutory date' approach in either of two ways:

- Deem the taxpayer to be resident in the area in which resident on the first day after arrival (last day before departure);
- Exempt from tax anyone not resident in the UK on the statutory date.

The former approach is, for example, that followed in Canada. The latter is on the face of it simpler, but wide open to exploitation, in particular by migrant workers who might take care never to be in the country on 6 April.

Overall, as Layfield found 16 years ago,[3] overseas experience does not seem to suggest that local tax authorities have found undue difficulty in practice in establishing 'residence' by reference to a taxpayer's principal residence, or in the absence of that centre of economic activity. In the great majority of cases there would probably be no need to question the taxpayer's own statement in the tax return, or 'residence confirmation' (depending on what form the local income tax takes). As a matter of law, however, it would seem desirable that the location of a taxpayer's residence for local income tax should depend on the facts, and not (as, for example, for capital gains tax, where the market pressures work quite differently)[4] on the taxpayer's election; and that there should not be free scope for high income people to claim to have their 'principal residence' at accommodation addresses in low tax areas.

On that basis a local authority could have a right to challenge a taxpayer's claim, if it did not appear to correspond with the facts; and the existence of that right could itself be enough to ensure that it seldom needed to be exercised. An appeal might lie on the facts to the local income tax Appeal Commissioners (perhaps to the panel for the area in which the taxpayer claims to be resident, who might be expected to be familiar with local practice). All parties - the taxpayer, the local authority in which he or she claims to be resident, and the authority which claims him or her as a resident - would presumably have a right to be heard.

Enforcement

No tax is viable, if it cannot be enforced reasonably effectively. The particularly vulnerable areas for local income tax are, not surprisingly, much the same as for the national tax; migrant workers and subcontractors, casual and part-time workers, people generally without a (known) fixed address. For a local income tax the authorities would need not only to identify people of this kind with taxable incomes, and collect tax from them (which can be difficult enough), but to attribute to them a particular local area. It is possible that in some areas of activity - for example, perhaps in the less formal areas of business - local knowledge could add significantly to the effectiveness of the national tax system.

One requirement, for any effective tax, is reasonably good voluntary compliance from the vast majority of taxpayers: they must feel the tax to be reasonably fair (so that non-compliance is not seen as morally justified) and they must perceive a genuine risk in non-compliance (so that it does not become something that 'everyone does'). For this reason, as well as for the potential direct threat to the revenue, a second requirement is that the authorities should be able to take reasonably effective action against evasion.

As always, it is a question of balance. No national tax system can be 100 per cent secure, and there is no reason to expect higher standards from a local income tax. For example, it is said that the Japanese have had a rule of thumb, expressed as 'Ku-Ro-Yon';[5] roughly 90 per cent of employment tax is paid voluntarily, 60 per cent of self-employment tax, and 40 per cent of farming tax. In other countries the figures are different. But experience indicates

something of a similar dispersion of experience, as between tax deducted from employment and other income at source and other collection arrangements, and as between more and less formal sources of income. In particular, UK experience with the Community Charge has left a number of local authorities very aware of the potential difficulties of collecting small amounts of tax direct.

A later chapter discusses two possible techniques which might contribute to more effective enforcement of a local tax:

- A register of taxpayers, and their addresses, each with a unique reference, and a reference to the appropriate local authority, maintained and used jointly by the central and local authorities (Chapter 8, pp 59-60);

- A withholding tax for employment income (and the special subcontractor arrangements), and investment income, at a rate which would encourage taxpayers to identify their local area of residence, and which would secure at source at least a reasonable proxy for the correct tax in those cases where information is not available at the time (or in some cases ever) to charge the correct local rate (Chapter 8, pp 60-62).

Notes

1 *Administration Options for a Local Income Tax,* John Kay and Stephen Smith, IFS, 1986.

2 In principle, it would seem inappropriate in an income tax for a taxpayer with houses in two local authority areas to pay local income tax twice on the same income (a different kind of potential double taxation). On the assumptions in this report, however, both houses would be liable for Council Tax.

3 Cmnd. 6453, Appendix 8; Report by Cooper and Lybrand Associates Limited.

4 For capital gains tax the market incentive will as a rule be for the

taxpayer to nominate the most valuable of his houses as his principal residence; and that will commonly, if not invariably, reflect the facts. For a local income tax there would be no basis for any similar presumption.

5 *The Japanese Tax System*, Professor [illegible] Ishi, The Clarendon Press, Oxford, [illegible].

CHAPTER 5

AN HYPOTHECATED INCOME TAX (OPTION A)

THIS IS AT ONE EXTREME of the range of options with minimal local involvement and maximum central government control. Many would not regard it as a local income tax at all.

However, it is perhaps worth looking at briefly: partly to help set the context for the later more radical options; and partly because it has perhaps some features in common with those local income taxes abroad which are collected by central government, on the national tax base, within rates controlled by central government. A 'Layfield' local income tax (Option B) with a low 'cap' on the rate of tax might not in practice be very different from an hypothecated tax.

Under Option A there is no structural link between what any local authority spends and the income tax that its local residents pay. Nor does any local taxpayer pay income tax to the local authority. Thus, by the criteria of local authority responsibility and accountability Option A rates at best a low score. Its aim might be:

- To bring home more dramatically to local taxpayers the cost of local authority expenditure. For example, some people may find the figures of total local expenditure (some £50bn) so large as to be almost meaningless. They might find it easier to relate to a statement that it is costing them, say, 6p or 9p in the £ on their income tax (in addition to their Council Tax). The usual media techniques would be available to central and local government to publicise the figures.

- To give local authorities some more assurance of their future revenue than they now have from the annual grant negotiations with central government. The uncertainty would, of course, remain that Parliament could legislate at any time to change the formula.

However, (as with the indexation of income tax thresholds) there would be a statutory presumption of continuity and the onus would be on central government if it wished to change that. (Any formula would need to take account of the fact that the UK income tax is an annual tax which ceases if in any year Parliament does not pass new legislation to change it.)

In brief, the effects of an hypothecated tax would essentially be presentational. By the same token, it would require little change to the national tax system (beyond, perhaps, some more detailed statistical work on the distribution of taxable incomes between local authority areas). It would therefore be relatively quick to implement, cheap to run, easy to collect and flexible; and it would imply no change in taxpayer confidentiality.

CHAPTER 6

A MIXED LOCAL SURCHARGE AND HYPOTHECATED OR 'LAYFIELD' TAX (OPTION B)

THE SCHEME DEVISED by the Layfield Committee in 1976 was an ingenious compromise, designed to graft a genuine local tax on to a basically rather incompatible national tax rootstock.

Layfield seems to have started from two basic perceptions:

- It would be out of proportion (the 'tail wagging the dog') to seek to change the national tax system to accommodate a local income tax; and critically, therefore, out of proportion to change the UK's present national (cumulative) PAYE system.

- It would be unduly expensive (see p.24) to have a system in which the national tax focuses its resources on pre-year and in-year coding, and in addition a local tax focuses on end-year returns and assessment - with individual taxpayers' affairs being processed up to three times in a single year.

For employment income, therefore, a Layfield scheme would rely on the present PAYE system to continue to collect the right amount of (national and local) tax for the vast majority of employees. For this purpose:

- Each local authority would set a rate of local income tax for its area and inform the Inland Revenue accordingly.

- The Revenue would establish the local authority area in which each employee was resident, perhaps with local authority help.

- The Revenue would add the appropriate local tax rate to the

national tax rate for each employee, and (through an extension of the PAYE coding arrangements) instruct employers to apply the appropriate aggregate (national plus local) tax table accordingly.

• The Revenue would not ask employers to calculate or account separately for the national and local constituents of the total tax bill. It would [illegible] the yield of the local tax to each local authority on a [illegible] basis.

For self-em[illegible] income the same first two steps would apply in much the same way. When the self-employed taxpayer submitted returns and accounts, the Revenue would similarly add the local to the national tax rate, to calculate the overall tax rate, and assess and collect tax accordingly. The Revenue could distribute the proceeds to each local authority on a statistical, or possibly an actual basis.

Investment income would present a different problem:

• To keep down administrative costs, it would remain essential that the tax deducted at source should continue to be the marginal rate of tax for the vast majority of employees, so that they have no need to submit an annual tax return (see p.18).

• However, for a variety of practical reasons, including the common use of nominees, it would hardly be realistic to expect banks, building societies, companies etc. to deduct tax at different rates according to the local residence of each beneficial owner of an investment.

• At the same time there would be the potential loss of equity,and also risks of distortion, or arbitrage, if the tax system opened up a wide new structural imbalance between the overall (national plus local) rates of tax on earned and investment incomes.

The Layfield solution was to cut the Gordian Knot. It charged local income tax at a flat rate, regardless of the particular local authority area in which the beneficial owner of the investment was resident, in addition to and along with the national withholding

tax on investment income. Effectively, it contented itself with an hypothecated tax on investment income.

Local responsibility

The strength of this approach is that local authorities would be free, subject to any limits set by central government, to set their own rates of local income tax, and to apply those rates to earned incomes, which in practice represent the lion's share of personal incomes. There would almost certainly be practical constraints (see below) on the number of different rates that the system could reasonably accommodate.

Local authorities would not have this responsibility for investment incomes. This would reflect an underlying appreciation that the amounts of tax at issue here would be much smaller, and the costs of imposing a local (locally variable) rate of tax on investment incomes relatively much greater. There would be political issues here. For what it is worth, there are overseas precedents for a local authority exercising taxing power over earned and investment incomes (Canada), earned but not investment incomes (Sweden), and investment but not earned incomes (New Hampshire, USA).

Accountability

It is difficult to be confident about how a Layfield scheme would be perceived by local taxpayers, and how much it would therefore add to local authorities' accountability.

The fact would be that most people would pay different amounts of income tax, according to the local authority area in which they were resident. Arguably, they would be acutely conscious of this - as they have been of different rates of Community Charge. As with an hypothecated tax, the usual media techniques would be available to publicise the results - and the differences between local authorities.

As against that, it is of the essence of Layfield that the local tax is integrated with the national tax and administered by the Inland Revenue. It is arguable that many people tend to focus simply on the top and bottom lines of their pay slip: the rate of pay and the amount they take home. To the extent that this is true, people might just lump local tax in, more or less indiscriminately, with all

the other deductions and stoppages from pay - national tax, National Insurance, pension contributions, etc. The Layfield Committee itself described its system as "relatively imperceptible".

Speed of introduction

It was thought at the time that a Layfield scheme would take in the region of five years to implement. IT support has meanwhile become much more powerful and sophisticated. In the final analysis, the timetable would be dictated by the basic requirements summarised on page 30.

Cost of administration

After detailed discussion between the Committee and the Revenue, it was estimated that the Layfield scheme would cost in the region of 12,000 or 13,000 additional staff-years in the Revenue on a manual basis - perhaps 25 per cent less with the then envisaged computer support. Though the scheme was designed to introduce a genuine local responsibility with a minimum added cost, the new local tax would have required large amounts of new information each year (about taxpayers' residence) as well as new procedures (to communicate that to employers) - neither of which was needed for the national tax. All the present (very expensive) requirements for the national income tax would have remained.

Only the Revenue would be in a position to update that estimate; and they would need to do a highly detailed exercise, on the basis of a precisely specified scheme. It is possible that new developments in optical character recognition technology might very significantly reduce the cost of handling returns from taxpayers, and in particular very simple returns or declarations confirming their principal residence. However, getting in and processing 20 million or so returns - and communicating revised codes to employers etc[1] - is never likely to be a cheap business, even if the amount of information on these returns is fairly limited and machine-readable.

There would also have been significant compliance costs for employers - in particular, as always, the smaller employers without IT support - to put themselves in a position to apply the right (national plus local) rate of tax to each employee. It is not unknown

in other countries' PAYE systems for employers to have to run several tax deduction systems in parallel (employers in New York may have to deduct tax from payrolls on behalf, separately, of the IRS, New York State, and New York City). However, the UK PAYE is already complex. The Layfield Committee suspected that employers would find a local income tax deduction unmanageable, unless taxing power was restricted to a limited number of top tier authorities, and the rates of tax were restricted to steps of perhaps ½p or ¼p.

Within this general approach, Layfield envisaged that it would be for the Revenue to take information from the taxpayer about address and local authority, and accordingly to instruct the employer what rate of tax to apply to each employee (Revenue notification). In principle, it would be possible to look for a rather different division of the work between the Revenue and employers. For example, it might be possible to require the employee to notify the employer of a 'principal address' and post-code; and for the employer then to be responsible for identifying the relevant local authority area and tax rate (employee notification) - consulting the Revenue, presumably however, in certain difficult or doubtful cases.

The latter approach might be seen as consistent with the trend of some recent developments to 'privatise' some of the costs of running the tax and social security systems. As against that, earlier experience suggests that employers might well be concerned at the implications for their costs of taking in, and maintaining for Revenue audit, large numbers of new bits of paper from their employees, and particularly concerned by any proposal that made them responsible for exercising judgement on tax claims from their employees. Arrangements would be needed to handle those cases where (unknown to the employer under present circumstances) the employee's code takes account of matters irrelevant to his current local income tax liability - for example, an underpayment of national income tax in an earlier year, or some investment income not taxed at source.

Beyond that, the day-to-day running costs would seem likely to depend very much on the quality of IT support that could be made available to the individual employer - particularly, as always, the smaller employer.

Confidentiality

Local authorities would have no access to data about an individual's financial affairs. All operational work would be handled by the Inland Revenue.

There would be a choice of approach for information about a taxpayer's residence. The work could be done wholly between the Revenue and the taxpayer based on a simple annual return; or the local authority might help to keep the address register up to date and complete.

Collection in-year

Subject to the outcome of the Schedule D consultative document (see above), and any necessary consequent new legislation, a Layfield scheme does not seem to pose any very difficult new questions for collection.

Flexibility

As noted above, Layfield felt that the administrative costs to employers would almost certainly constrain the number of local authorities empowered to charge local income tax, and the range of rates that they could choose.

So that the Revenue could include in its autumn coding review the information about a taxpayer's address, 'residence' for local income tax purposes would have been established in the autumn of the preceding year. It is fairly common in overseas countries for residence for local income tax purposes to be determined by reference to a single point of time - though usually at the beginning of the fiscal year; though there would clearly be a disadvantage, to the extent that local authority finance committees needed to settle a tax rate very long before the beginning of the financial year.

In a few countries there is provision for apportionment between local authorities when a taxpayer moves residence in the course of the year. However, if this were thought worth while, it would be relevant to a possible end-year assessment system, rather than to a Layfield system.

Notes

1 It was estimated that the main components of the staff cost of the Layfield proposals were; issue and examination of returns, 20 per cent; coding, appeals and notification to employers, 30 per cent; extra assessment, 30 per cent; non-PAYE taxpayers and queries etc. 20 per cent. Revenue evidence to Select Committee on the Environment, H.C.217-vii, 1982.

CHAPTER 7

A LOCAL SURCHARGE ON INCOME ADMINISTERED BY THE INLAND REVENUE UNDER THE PRESENT SYSTEM (OPTION C)

THIS HAS ALL THE local features of the Layfield Option B. In addition, investment income is subject to local income tax to the same extent as earned income.

The analysis in Chapter 6 in relation to earned income, and in particular to employment income taxed under the present cumulative PAYE, is largely relevant, and is not repeated here.

The objective of extending local income tax to investment income might be increased local responsibility and accountability. All local incomes would feel the consequences of individual local spending decisions. The minority of people largely or wholly relying on investment income, including retired people, would not be immune.

The disadvantage is cost. The withholding tax rate would cease to be the marginal rate for most taxpayers. If as a consequence large numbers were required to send in annual tax returns, the costs, on top of the present pre-year and in-year handling, could, for the reasons explained in Chapters 2 and 6, be formidable. The basic problem would be much the same, whether the tax were administered by the Inland Revenue (as assumed here) or by local authorities (as in Option D).

There are various devices that could reduce that cost. For example, a flat-rate local withholding tax could be added to the national withholding tax on investment income generally (as in Option B); and only incomes above a given threshold could be subject to a locally determined (variable, but presumably higher)

local income tax. In effect, this would be a compromise between Options B and C.

This option is included as part of the logical progression suggested in Chapter 2. For practical purposes, however, there must be a point beyond which it would not be sensible to add new policy options, requiring a lot of end-year work, to a PAYE system of the present kind, and a point at which the balance of advantage would shift decisively towards refocussing the tax system generally on end-year returns of income and assessment.

The main implications of a local income tax related, not to the present cumulative PAYE system, but to a non-cumulative end-year system, are discussed in Chapter 8.

CHAPTER 8

LOCAL TAX, COLLECTED LOCALLY, ON INCOME AS REPORTED TO THE INLAND REVENUE (OPTION D)

Implications For The National Tax System

A radical new step

Conceptually, Option D starts from the position in the previous option (local authorities set a local tax rate for all income, earned and investment); and it then adds a new responsibility for local authorities to assess and collect that tax from individual taxpayers, on the basis of Inland Revenue data about taxpayers' incomes.[1]

In practice, as the discussion on Option C foreshadows, it probably presupposes a fundamental change in the national tax system. It requires the Inland Revenue to have information, which it does not now have, both about employees' residence and about their total incomes. This, in turn, requires people generally to send in annual returns of income and the Revenue to process them. And at this point it would not be easy to justify the costs of cumulative PAYE. The object of cumulation is to end the year having deducted the right amount of tax. A local income tax of this kind, applied to investment income, would in all too many cases make that impossible.

Thus, Option D relaxes the assumption hitherto, that the present PAYE system is retained broadly in its present form. The assumption here is that the tax system generally is refocussed (both for national and for local tax) towards a non-cumulative PAYE and a much more general issue of returns, leading to end-year assessment.

It would certainly be possible, under a tax system of this kind, for the Inland Revenue to collect local tax on behalf of local authorities - very much on the same principle as in Options B and C. The implications for local responsibility and accountability

would be very much the same as under those options. As the 1981 Green Paper acknowledged,[2] the administrative costs could be very much less, as taxpayers would already be making a return for national tax purposes, and would not need to send in a separate return for local income tax.

However, a further assumption underlying Option D is that, at the point where the system contemplates a local income tax based on end-year assessment, it becomes possible to contemplate (though it is obviously not an operational requirement) that the local authorities (not the Inland Revenue, as in the previous Options) should issue those assessments in their own names, much as they now issue demands for other local taxes.

A different PAYE system

Some of the strengths and weaknesses of the present cumulative PAYE system were summarised in Chapter 2 (pp 23-5). Non-cumulative systems also have strengths and weaknesses, including the need to handle the so-called 'paper mountain' of tax returns in the few months after the year end. It would be well beyond the scope of this paper to try to argue to a conclusion the balance of advantage, or develop an alternative, non-cumulative, national PAYE system. Layfield argued that it is not a change that many governments would be likely to make solely for the purposes of a local income tax.

As a basis for the analysis in the rest of this chapter, however, it may be convenient to note briefly the main features of the kind of PAYE system that is familiar in the United States and many other countries. Tax is deducted from employment income on a more or less broad-brush basis during the year, non-cumulatively. The employee makes a return of his income at the year-end. In the United States, though not in many other countries, the taxpayer calculates his or her own tax liability and pays it, at the same time as submitting the return: self-assessment. There are strict and strictly enforced rules for compliance.

If the United States is an example:

• The national revenue authorities could on balance (after the initial investment in change) have significantly lower running

costs. They have much less routine work (though that becomes highly seasonal) and can concentrate more on customer service and compliance.

• Taxpayers have significantly higher costs: they have to send in annual tax returns. They have to accept much more responsibility, as compared with the revenue authorities for keeping their tax affairs straight. As a rule - partly because of the nature of non-cumulation, but also to help secure adequate compliance - they will suffer an over-deduction of tax during the year, with a right to claim repayment after the year-end.

• The position of employers is less clear-cut, depending on the nature of the employer, the IT support, and the precise tax structure (including state or other local tax structure) that the employer has to operate.

• The tax structure is capable of handling a wider complex of rates, reliefs and allowances, to be claimed by the individual taxpayer in his tax return (though the Zero Bracket Amount serves in the United States to encourage people with no more than small claims not to itemise them, but to send in the very simplest form of tax return, the 1040 EZ).

Recent Australian experience illustrates how - in this case with the inducement of a guarantee of prompt handling and repayment - it can become possible to increase the speed and reduce the public sector cost of handling large numbers of personal tax returns, if taxpayers find it worthwhile to employ professional tax agents to prepare their tax returns, and if in consequence the returns can be submitted to the Revenue authorities in electronic, not paper, form.

The pattern of a local income tax in the context of a non-cumulative national PAYE system might be:

• The Inland Revenue would receive annual returns of income from taxpayers (or their agents) after the year-end.

• The Revenue would use this information to charge or repay national tax.

• The Revenue would also pass information about a taxpayer's total taxable income to the relevant local authority, to enable it to charge or repay tax accordingly.

• The local authority would be responsible for all subsequent operation of the local income tax.

Local responsibility

This approach adds a significant new measure of local responsibility. Local authorities do not only set the tax rate. They send out a separate bill to taxpayers. They collect (or repay) the money directly and they are responsible for enforcing payment of debt, when that is necessary.

Local accountability

To the extent that the payment arrangements are not wrapped up with national tax, national insurance, etc., the local nature of the tax might be more perceptible to taxpayers, and local authorities more accountable accordingly.

Speed of introduction

The presumption here is of an underlying radical change in the UK tax system. That itself would need, not only new IT support and training, but probably a physical re-shaping of the tax office network. If one thought of 'five years or more' for implementation, that would at this stage be not much more than a conventional way of indicating a period of some years after the legislation was passed. As always, much would depend on the details and the priority which the government of the day attached to the change.

Preparations for a local income tax of this kind might take a similar period (as in the Layfield scheme). If the national and local changes were proposed at the same time, preparations could to a significant extent go forward in parallel. For implementation, however, prudence would probably wait a year or so for the new national tax system to bed down, and for the links between the two systems to be tested in live working, before using it as the basis for a new local income tax.

Costs of administration

The national tax system

The working assumption is that the Revenue's costs in running the national tax system would on balance be significantly lower.

Exchange of information

The system would depend on the Revenue passing very large amounts of information to a variety of different local authorities: and then passing over amendments in the (important) minority of cases where new information comes in late, late claims are made, appeals succeed etc. The information would have to be very clear, very precise, and very reliable. With an operation on this huge scale, the system could rapidly break down, if a significant proportion of cases needed manual intervention to identify taxpayers, or their local authorities, or if it often led local authorities to bill the wrong taxpayer for someone else's tax.

It would probably be a requirement of such a system that the Revenue and local authorities jointly maintained a database which:

- Identified each taxpayer by a unique reference number (which could be the NINO or some other arbitrary number);

- Identified each local authority similarly by a unique reference number;

- Attributed each taxpayer, according to his residence, to each local authority.

The annual tax return could be a principal source for the database, but local authorities could sometimes be well placed - and have an incentive - to supplement it, using their local knowledge.

Chapter 2 noted developments in the Revenue's present systems, which could be relevant for this kind of use; and there are already some areas of electronic exchange of information between the Revenue and local authorities for the purposes of the Council Tax. There would need to be a substantial investment (in compatible technology) by both central and local government. But it seems a reasonable judgement that technology could handle data transfer

and matching on this scale within the period of time at issue here, if the data were clear and unambiguous.

A possible refinement, which might help equity and compliance, at some additional running cost, might be for the Revenue to charge a flat-rate, and perhaps mildly penal, supplement to the national tax rate in any case where at the time of the annual assessment it had evidence of liability as a UK resident, but no evidence as to which local authority was responsible. The taxpayer might have a right to repayment on identifying himself (within a given period) to the proper local authority. There is a link here with the general prospect for withholding taxes, discussed further below.

The use of a unique 'Identifier' of this kind, shared by the relevant tax authorities, is fairly common in overseas tax administrations. It would be for political judgement - possibly coloured by experience of the Community Charge - whether it would be acceptable in the United Kingdom. It would not necessarily require the kind of national card or registration scheme that is required in some overseas countries. It would not be necessary, nor necessarily desirable, to integrate such a register in any way with the voting register.

Withholding taxes

It would significantly affect the administrative arrangements, and cost, and in particular the costs of collection whether local income tax was withheld at source from employment and investment income, and, if so, how.

For employment income, there would be three broad routes:

(i) Deduct at the correct local rate

(ii) Do not deduct

(iii) Deduct at a uniform flat rate.

The technique at route (i) has a fair amount in common with the Layfield Tax (Option B) and has many overseas precedents. In each case the taxing authority has to instruct the employer to deduct tax at any one of a range of tax rates according to each employee's area of residence. And for this purpose 'residence' has to be determined at some point before the beginning of the fiscal year.

For the tax authorities, the information would come from the taxpayer's annual tax return [illegible] contrast with Option B) the taxpayer would in any [illegible] for national tax purposes. For employers, however, [illegible] additional compliance costs of handling multiple rates [illegible] less than under Option B, with few if any offsetting savings in many cases; and in addition employers would have to account separately to each authority for the tax deducted.

As noted in the discussion on Layfield in Chapter 6 employers in other countries appear to cope with a range of tax deductions and separate accounting. In some cases (as in the United States) at least some of the coding instructions may come direct from the employee; in other cases (as in Japan) instructions may come from the revenue authorities.[3] However, given that the system envisages an end-year adjustment in any event, it is for judgement whether the degree of sophistication in the deduction system would be cost-justified, if it was not dictated by the broader political terms of a federal constitution.

Route (ii) uses no withholding tax for local income tax purposes. In this respect it places no new costs on employers or the Inland Revenue. It would be wholly for the local authorities to assess tax on employment and investment income, as on self-employment income - and to collect it (see below) after the year-end. The familiar disadvantages would follow: tax not withheld at source would generally be more difficult to identify and more expensive to collect; and (where it comes in at all) it comes in more slowly. For what it is worth, other countries running a local income tax as a rule include some form of deduction at source, at least from employment income.

Route (iii) would be a middle course, entailing a certain loss of perceptibility. Employers etc. would deduct tax at a flat rate, including both the national tax and a provisional deduction for the local tax. Employers would pay the whole amount as a lump sum to the Inland Revenue, who would pass on the local element to local authorities (as in the Layfield tax). After the year-end, local authorities would take account of the difference between the 'provisional' deduction and the correct local tax rate, at the same time as they take account of other changes and adjustments in

calculating whether the taxpayer has additional local tax to pay, or a repayment to receive.

Again a possible refinement might be to set the 'provisional' local tax deduction at a level towards the upper end of the reasonable range. So, most local authorities might normally expect to make a repayment of tax (much cheaper than to pursue direct collection). Most taxpayers would have a further inducement to get their returns in promptly. At the margin, where a local authority considering an increase in the local tax rate might need to contemplate moving from a repayment to a collection mode, the withholding tax machinery might have some restraining influence, even if it was not of course a formal 'cap'.

For employers, route (iii) would imply little or no addition to their present PAYE work. For the Revenue also, the withholding tax arrangements might be much simpler than under route (i) - though there would be some additional accounting and statistical work.

For investment income, for the reasons explained in Chapter 6, the choice would be between routes (ii) and (iii). Deduction at the correct local tax rates for each authority is not a realistic option.

Collection

Under this option, local authorities become responsible (depending on the withholding and other arrangements) for collecting tax from or repaying tax to some 25 million income taxpayers, and up to another 15 million people with taxed investment income. This is additional to the Inland Revenue's work for the same taxpayers and to the local authorities' own work in collecting other local taxes, including the Council Tax. It would be the largest continuing cost of a local income tax of this kind (given that the taxpayer would be making a return of his income to the authorities in any event), after the initial investment in change, including the register of local residence.

After the experience of the Community Charge, no one is likely to discount possible costs and difficulties of local collection; and any habits of non-payment of tax are likely to be much easier to acquire than to lose. That said, the collection task for a local income tax would differ from that for the Community Charge:

• The tax population of some 25 million would not only be less than that of the Community Charge (35 million). The 10 million difference almost certainly includes a very high proportion of the most difficult cases: people without jobs or fixed addresses; people without substantial assets; and people generally with small means who have special difficulty in, or objecting to, paying.

• There would undoubtedly be a high degree of commonality between the taxpaying populations for local income tax and the Council Tax. The government White Paper of 1986[4] estimated that there were some 20 1/2 million households in Great Britain, of which some 4.3 million included 'multiple tax units'.[5] Obviously, it would cost more to collect two taxes from the same taxpayer than to collect one tax; and the costs of collection would also be affected by the decision whether to give local authorities generally the right to charge both taxes, or to allocate the right to charge each tax to separate tiers of local government;[6] but the costs are unlikely to be twice as great. At a minimum the collection procedures - direct debit, instalment arrangements etc. - could be common between the two - even if the two were not collected together.

• If there was an effective withholding tax on employment and investment incomes, there could both be less need to pursue marginal cases (because provisional tax had already been deducted) and less difficulty in doing so (because the taxpayer might have an incentive to come forward and claim repayment).

The Schedule D consultative document floats the possibility that, as in a number of overseas countries, taxpayers might make provisional payments of tax during the year, by reference to their previous year's income. If this suggestion bears fruit, it would be for consideration whether similar arrangements would work for local tax on self-employment (and in due course possibly other) incomes.

Confidentiality

Under Option D the local authorities would have access to information about a taxpayer's total taxable income, and also about his collection performance. They would not need to have information about the detailed make-up of his personal or financial affairs.

Collection in-year

Under route (i) tax would flow into local authorities monthly or quarterly through the year at the rate set by each local authority for the year. Under route (ii) tax would not come in until after the year-end except so far as provisional payment arrangements were in place. Under (iii) tax would flow in through the year, but not reflecting the rate set by the local authority for the year, and local authorities would therefore face a lag between their budget decisions and their effect on the revenue flow. It would be for consideration how the cash flow benefit of deduction at source - in contemplation of a possible later repayment - should be shared between employers etc., central government and local authorities.

There could be a particular problem for local authority finance committees in the first year or so. For the reasons recognised in the Introduction, the forecast yield of a local income tax at below the national or English regional level shows two linked, but operationally quite separate, features. The smaller the geographical area:

- not only is the variation in revenue greater, as between one area and another;

- but also the forecasts themselves are subject to a greater margin of error.[7]

To handle the former feature, it was suggested that there would be a need for some substantial equalisation measures: for example, it could be possible to calculate a 'standard yield' for a 1p rate of local income tax; and, in the revenue support arrangements with central government, take account of the extent to which taxable income, capable of producing a 'standard' 1p yield in an individual authority, exceeded or fell short of the 'standard'. To handle the latter feature (over and above the obvious advantage in that context of increasing the statistical sample, as part of the preparations for the new system), it might be desirable for the equalisation measures in the first year or so to take account, not only of the actual variations in taxable income between different local areas, but also of the variations between forecast and actual out-turn.[8]

Flexibility

Option D, if either route (ii) or (iii) is followed, does not seem to face any severe external constraint on the number of rates of tax (a whole 1p or a fraction of 1p) to be set by each local authority, or (within reason) on the level of local authority having the power to tax. Route (i), however, would [illegible] much the same constraints as the Layfield scheme (Option B).

Notes

1 Possible versions of a scheme on these lines were discussed in evidence to the Select Committee on the Environment, and in the Report of the Committee. Some versions assumed that the present PAYE arrangements would continue; others assumed a change in the basis of PAYE, as in Option D. Second Report from the Select Committee on the Environment: Inquiry into Methods of Financing Local Government: Session 1981-82, H.C. 217.

2 Alternatives to Domestic Rates, Cmnd.8449.

3 In earlier discussions, on the 1972 Tax Credit scheme, UK employers expressed concern that 'employee coding' might mean significantly higher compliance costs for them, as compared with the (now largely computer-driven) bulk notification from the Revenue.

4 Paying for Local Government; Cmnd.9714.

5 At that time, however, counting a married couple as a single unit.

6 See footnote 4, Introduction, p7.

7 Published estimates of taxable income by county and Scottish region for 1988-89 show 15 counties and regions where, because of the low sample size, there is a 5 per cent chance that the actual number is 25 to 40 per cent higher or lower than the

figure shown, and 4 areas where there is a 5 per cent chance of the error exceeding 40 per cent. Inland Revenue Statistics, 1991.

8 It might be desirable of this purpose for the equalisation measures to reflect taxable income, rather than tax collected. The objective might be to equalise taxable capacity, rather than collection performance.

CHAPTER 9

LOCAL TAX, COLLECTED LOCALLY, ON INCOME REPORTED LOCALLY BUT ON NATIONAL TAX BASE (OPTION E)

THIS OPTION has all the 'local' ingredients of Option D, including setting the rates of tax, assessment and collection. In addition, local authorities (not the Inland Revenue) are responsible for establishing a taxpayer's income.

At this point, we are contemplating an operationally free-standing local tax. Taxpayers make returns of their income to their respective local authorities, as well as to the Inland Revenue. If there is a withholding tax, it is the local authorities who give employers etc. instructions on any local element; and it is to local authorities that the money is paid.

However, local authorities are not free to depart from the national tax base, set by Parliament at Westminster. So, a taxpayer does not have to learn one set of tax rules for the national income tax, and a second set of rules for local income tax - plus perhaps a third set, if he changes his residence.

Responsibility and accountability

Under Option E the local authority takes full operational responsibility for raising the local income tax. The local taxpayer is further reminded of its local character, not only when paying tax, but also when sending in his or her annual tax return to County or City Hall.

Speed of introduction and cost of administration

In one sense the change is more straightforward than the change to Option D. In principle, the local income tax need not be affected by the shape of the national tax administration (cumulative or non-

cumulative PAYE), or dependent on changes in it. In a wider sense, however, the change is much greater as local authorities need to acquire all the capabilities, including for example the local equivalent of a tax inspectorate and revenue executives (though not the tax policy capability) of the Inland Revenue. It would be up to each authority to decide whether to have a local income tax and, if so, how to run it. On the face of it, however, there is little reason to expect that the cost to local authorities overall would be any less - perhaps because of the loss of economies of scale rather greater - than those of the Revenue in running the parallel national tax system.

Confidentiality

Under Option E, local authorities necessarily have access to the full range of information which the Revenue needs to establish someone's taxable income. They do not in principle rely on receiving information from the Revenue - though the Revenue and local authorities might on occasion exchange information, perhaps for compliance purposes.

Collection in-year and flexibility

The options and implications here are in principle much the same as in Option D. In practice, a flat-rate national withholding tax (route (iii) in Chapter 8) looks perhaps a less natural element in an operationally free-standing local tax.

Overall this Option - in something the same way as Option C - is included largely as part of the logical progression in Chapter 2. It may be felt that it adds potentially heavy costs to the local administration for relatively small additional benefits. Why require the taxpayer to submit a local tax return, if legislation requires that return precisely to replicate the national tax return? For what it is worth, most overseas systems, when they require a separate local tax return, allow local authorities at least some freedom to vary the tax base.

CHAPTER 10

A WHOLLY FREE-STANDING TAX (OPTION F)

UNDER OPTION F a local income tax is wholly free-standing, both for operational and for policy purposes. Operationally, Option F could run in much the same way as Option E. By contrast with Option E, however, each local authority is free to set its own tax base: for example, to set the tax threshold higher or lower than the national tax threshold; to give special local reliefs and allowances, or to deny reliefs that Parliament has given against the national tax. Under Option F, in particular, local authorities could be free to set their own more or less progressive schedule of tax rates for higher levels of incomes.

Responsibility and accountability

Option F clearly takes us to the further extreme of the spectrum, with maximum local responsibility and accountability, and minimum or no central government control. Local taxpayers make their own local tax returns, which need not replicate their national tax returns. Each local authority undertakes its own version of the national income tax policy debate before each Budget: not only the argument about a higher or a lower tax burden, but also about incentives versus neutrality, public expenditure versus tax expenditures etc., etc.

In principle, each local authority could have untrammelled freedom to take its own income tax policy decisions, without regard to the national tax base. In practice, local authorities might choose to stop short of that extreme. For example, the US Courts have said that: "A State's power to tax net income of residents is almost limitless".[1] However, most US States tend to adopt many of the main features of the US national tax laws, adding their own special variations at the margin. That said, there are some large exceptions. And it is difficult to find a State (though some New England States come near it) that does impose a local income tax, but does not add

on some local bells and whistles. Most States have some degree of progressive rate schedule on higher incomes.

This approach is perhaps implicit in a Federal constitution: anything less would be an infringement of States' rights. In a unitary constitution a power to vary the tax base could be statutorily constrained in various ways:

- by having different tax rates on different types of income, but not tampering with the tax base itself;

- by varying tax thresholds, but not tax reliefs and allowances;

- by varying only within certain parameters; to set a range of tax rates within a given maximum or 'cap'; or varying tax thresholds within a given percentage margin.

Under this option local responsibility and accountability is not restricted to how much local taxpayers should pay for local services. Local authorities are given more or less full access to the powerful tool of the income tax to influence (through the thresholds and rate schedule) the distribution of incomes and (through reliefs and allowances) the pattern of private expenditure and investment.

Speed of introduction, cost of administration etc

In all operational aspects, Option F could be effectively identical with Option E (see Chapter 9; these arguments are not repeated here). Both Option E and Option F are bound (for a given population) to be the most expensive to run overall.

Option F could, in certain variants, also have higher private sector compliance costs, as local taxpayers and their agents have to bear in mind that a given item of expenditure needs to be treated in one way for national tax, in another way for (say) Kent tax, and in a third way for (say) Sussex tax - and so forth. If a local income tax in the UK were introduced at County level, the areas would be much smaller than, say, the areas of North American States.

The potential compliance costs are relevant to the suggestion that a free-standing local income tax, charged at a lower rate than the national tax, might be able to run on a simpler basis, without the complexities found necessary in the national system to mitigate

anomalies, or avoidance. The premise is debatable (against the background of recent devices to pay employees in gilt-edged stock, equities, or gold bullion, to avoid employers' national insurance contributions at 10.4 per cent). However that may be, there would be a significant compliance cost for taxpayers and their advisers, in coping with dozens, perhaps hundreds, of local tax rule variations. There is a possible argument in favour of greater local discretion in setting the reliefs and allowances for a local tax, to achieve possible devolutionary or constitutional objectives. But it is not based on simplicity.

Under some variants of Option F, local authorities could be free to vary the tax base in a way that would significantly affect the tax population, and thus their operating costs. For example, a local authority might choose one or more of the possible options to:

- Charge a relatively low rate of income tax with a relatively low or minimal threshold, imposing a new burden on large numbers of low income people who are not national taxpayers,(and adding to its own running costs accordingly);

- Charge a relatively high rate of tax on incomes above a higher threshold, making the overall income tax burden significantly heavier on the smaller number of people with higher incomes,(and reducing its running costs accordingly);

- Single out for taxation (or exemption) particular categories of income - such as investment or self-employment income - in such a way as to influence the pattern of economic activity in its area, to increase the tax rate (to raise any given amount), but perhaps to reduce the tax population (and running costs).

The range of possibilities here illustrates the questions for political decision summarised above.

Notes

1 Supreme Court, New York ex rel. Cohn v. Graves *et al.* (1937) U.S. 308, 57 S. Ct.466.

CHAPTER 11

EXPERIENCE IN SOME OTHER COUNTRIES

THE DISCUSSION in the earlier chapters has on a number of occasions paused to look sideways at the experience in other countries.

General

Perhaps the clearest single message from the comparison is the "sheer diversity" - to borrow a phrase from a conference on local government held in Paris in 1991[1] - of international practice. Within North America alone:

- Some US States tax incomes relatively heavily (up to 11 or 12 per cent in Montana and North Dakota), and others have no income tax (Texas);

- Some US States relate their tax assessments directly to the Federal tax assessment (Vermont and Rhode Island), and others calculate the State tax liability quite independently of the Federal liability (New York);

- Some US States tax investment income, but not earned income (Tennessee and New Hampshire), and in another State large municipalities charge a payroll tax (New Jersey);

- Some Canadian Provinces employ Revenue Canada to assess and collect the Provincial tax (Ontario), and another runs its own separate tax administration (Quebec).

All that suggests a need to be cautious before asserting that something 'must be done', or 'cannot be done', for the purposes of a local income tax. Somehow, the fact often emerges that some

country somewhere manages to do something that others perceive as unthinkable, and another survives without something that others perceive as indispensable.

That said, another clear message from the international comparisons - also emphasised at the 1991 Paris conference quoted above - is that each country's practice is rooted in its own constitutional and historical context:

- The most obvious difference is, of course, between Federal and unitary constitutions. In the one, the constitution may give primary taxing rights to the local authorities,[2] on which the State cannot trench without explicit local consent. In the other, local authorities may have no taxing rights beyond those explicitly granted them by the State government and Parliament. In this, as in some other fiscal matters, the United Kingdom and the United States are towards the two extremes of the international spectrum;

- In other less basic respects, also, the practice in different countries is a product of their own past. It is simple, but perhaps an oversimplification, to describe this as 'historical accident'. Rather, it tends to be a product of a series of deliberate political decisions, taken for what seemed at the time - and indeed may still be - good political, commercial or management reasons. However, the outcome may be a national practice that is acceptable in a particular country largely, if not wholly, because it exists, grew up over time in its own particular context, and is familiar there.

Whatever may be the explanation, the international comparison suggests a degree of caution, before concluding that, because a practice exists in one country, 'there can be no problem' in importing it into another country. For example, one might hesitate to assert that a taxpayer commuting into London would cheerfully accept the compliance burden of submitting 4 separate annual tax returns to 4 separate tax authorities, just because we are told that a taxpayer commuting from Connecticut into New York may have to do so.

Subject to all that caution - necessary in all international comparisons - some general trends can be traced. UK local authorities

are unusual - one speaker at the 1991 Paris conference described them as almost unique - in relying so heavily on one single concentrated form of local revenue. A good many other countries have some form - or rather a variety of different forms - of local income tax as one element in their fiscal armoury. Where there is a local income tax - and that is far from universal - the local taxing authorities may, or may not, share the administration with the State taxing authorities; but they will as a rule start from a common tax structure and system and at least start from a common tax base, even if they depart in detail (Chapter 2 has described the special issues for the UK in that respect). State and local taxing authorities are commonly authorised to share information for tax purposes.

The 1980s saw an international move towards lower tax rates - of both personal and corporate taxes - accompanied, and in part financed by, a broadening of the tax base.[3] This trend took its origin from a policy conclusion - in the first instance, perhaps, by the then UK and US Administrations - that the more interventionist tax policies of previous decades had not proved successful, and that a good tax system should seek so far as possible to be neutral: in brief, that the tax system should return to taxpayers the favour that the Cynic philosopher Diogenes once sought from Alexander, to "stand a little less in their light". However, it is also clear that the international trend was driven forward by market competition. At a time when information technology has given every business the whole world as its neighbour, and potential competitor, capital has become more and more mobile, without regard to national frontiers; and much the same is happening for some businesses and business people. National governments have felt themselves under pressure to offer international investors an environment, including the fiscal environment, not less attractive than that in their competitors. As the official Swedish paper on the 1991 tax reforms put it: "In an open economy like Sweden's, this choice [of tax system] must be made with special regard to the mobility of labour, investments and wealth".[4] Whatever the course of the future political cycle, it would be surprising if the forces of international competition did not continue, in one way or another, to exert pressures on national tax systems - and if similar pressures were not felt also at the local level.

The pattern so far has been of a certain *de facto* approximation. Within the European Community there are rules to proscribe discriminatory tax practices, of a kind that would distort competition, or impede the free movement of capital. However, the Commission has no proposals for the formal legal harmonisation of the personal income taxes at the national level; and the arguments of 'subsidiarity' would seem [illegible] carry still greater force at the local level.

By the same token, there has developed over the last 10 years or so what looks like a degree of approximation, or convergence, of national administrative systems. Of course, fundamental differences remain. However, at one end of the spectrum, countries such as the United States and Australia have been seeking ways of reducing the size or the cost of the 'paper mountain' involved in their systems of end-year assessment. People have explored the scope for relying more on information from the payers of income than on returns from the mass of individual taxpayers, or for encouraging taxpayers to submit simplified (and machine-readable) tax returns, not itemising a clutch of small claims. They have put a great deal of effort into developing a capacity to use Optical Character Recognition techniques, and still more effective direct electronic interchange of information, to handle paper more cheaply, or to dispense with it altogether. At the other end of the spectrum, Chapter 2 has outlined the work in the UK to develop similar capabilities, in response to the increase in the number of personal tax returns or claims flowing from recent policy initiatives, in particular from independent taxation and the abolition of composite rate tax on bank and building society interest.

Some individual countries

The Layfield Committee commissioned detailed studies of the tax systems in the United States, Canada and Sweden, and these countries have tended to figure largely in subsequent discussions.

The USA is, obviously, a familiar exemplar for a British commentator and the US system is already well-documented elsewhere. Chapter 8, in particular, has touched on the question whether the US Federal tax system may be relevant to the future of the UK national tax system. The basic division of responsibilities

between the Federal and the State authorities remains. The details of the local (State) income tax arrangements appear to be very firmly rooted in the US Federal Constitution.

In the **Canadian** tax arrangements, also, the relevant lessons, and the crucial link between the structure of government and the structure of government finance, remain broadly those that emerge from the work done for Layfield.

The **Swedish** tax system has changed fundamentally since Layfield reported. In 1991, as noted above, a country that was frequently held up as an example of purposive, or interventionist, tax policy joined the international trend of the past decade towards lower tax rates and a broader and more neutral tax base. At the same time Sweden took a radical approach towards the possible conflict of interests between central and local taxing rights. The central government (not the local authorities) has exclusive taxing rights over investment income. The local authorities (not the central authorities) have exclusive taxing rights over earned incomes, up to a level originally set in the 1991 paper at SEK170,000 (subject to indexation) - a level at which over 80 per cent of taxpayers with earned income would be subject only to the municipal tax. To help ensure that local taxing authorities did not exploit the 'tax room' thus created, a temporary 'cap' was placed on local tax rates. Both central and local income taxes, however, continue to be assessed and collected together under the authority of the National Tax Board (and it is said that this may have implications for perceptions of local responsibility).

The tax arrangements in **Japan** have, perhaps, tended to attract a little less comment, but appear to offer some interesting analogies with, as well as some interesting differences from, those in the UK.[5] At the most general level, the Japanese tax arrangements work within a unitary State, where there has historically been concern to support and develop strong democratic institutions at the local level; and within an island State, with wide internal disparities in population and incomes (and a consequent need for effective arrangements to equalise resources between the local authorities). More specifically, the Japanese income tax system is notable for the fact that (like the UK and Ireland) it works without troubling the great majority of ordinary people to submit an annual tax return;

but (unlike the UK and Ireland) it has substantial local income taxes. (The Prefectural and the Municipal Inhabitants Taxes, together, added up in 1990 to the equivalent of over half the yield of the national income tax.)

At the level of the national income tax the Japanese authorities have faced much the same issues, as those that the UK authorities have needed to face (see Chapter 2), in succeeding in running an effective 'non-assessment' system for the great majority of their taxpayers. They have done this with a relatively progressive schedule of tax rates and nothing resembling the UK's long basic rate band. The main techniques appear to have included:

• Arrangements that one commentator has described as "the most developed withholding tax system in all the world". Some 80 per cent of all income tax is withheld at source, by over 3½ million payers of income.

• A form of PAYE that deducts tax from employment income on a non-cumulative basis during the year, but requires the employer to make a cumulative adjustment at the year-end, to finish the year having deducted the right amount of tax from employment income for the year as a whole. (The detailed arrangements may reflect the pattern of Japanese employment).

• A quite strongly schedular system for taxing investment income. Certain small savings are exempt from tax (though recent reforms have cut down the scope of these exemptions very substantially). Interest from bank deposits is subject to a flat rate (and final) tax of 20 per cent (15 per cent national and 5 per cent local). Modest dividends may be taxed at a flat and final rate of 35 per cent. There are corresponding constraints on the set-off of expenses and losses.

In a number of these respects the Japanese tax system has evolved in a way that takes it some distance from the original principles of a comprehensive income tax and self-assessment, heavily influenced by US experience and advice, of the Shoup Mission in 1949.[6] As a consequence, taxpayers with only employment income, or with employment income and other income not

exceeding ¥200,000, do not need to file a national income tax return. A fairly high tax threshold also works to reduce the number of potential tax returns.

The Prefectural and Municipal Inhabitant Taxes are collected separately by the local authorities, but are based closely on the national tax:

- The tax base is effectively the same as the national tax base; but the personal reliefs may differ, and are commonly slightly lower.

- The tax rates are set locally within maxima set nationally.

- Taxpayers who have filed a national tax return, or who have only employment income, are excused from making a local tax return (the national tax authorities will pass on the necessary information to the local taxing authority).

On this basis, the local tax authorities will instruct employers to deduct local tax from employment income, and in other cases collect tax direct from the taxpayer by instalments. The liability will be based on residence on the first day of the tax year (January 1) and on the income of the preceding year.

The cost of collecting the national taxes generally in Japan is estimated to have been a little under 1 per cent in 1990 - less than the UK costs, but more than the US costs. Apparently, the total cost of collecting local taxes (not just income tax) is some twice the cost of collecting the national taxes; and there is said to be some debate, whether this is a necessary, and if so an acceptable, cost of local accountability.

Notes

1 Local Government Taxation: The Proceedings of the First European Conference of the Institute of Revenues Rating and Valuation. Paris, 1991.

2 For example, the Constitution Act 1867 granted exclusive jurisdiction to the Provinces with respect to direct taxation within the Province in order to the raising of a revenue for

provincial purposes; see also the decision in Cohn v Graves (Chapter 10, note 1).

3 These are conveniently documented in, for example, *Trends in International Taxation* by Professor D W Williams, International Bureau of Fiscal Documentation, 1991.

4 The Swedish Tax Reform of 1991. Ministry of Finance, Sweden 1991.

5 *An Outline of Japanese Taxes*, Tax Bureau, Ministry of Japan, 1990; *An Outline of Japanese Tax Administration*, National Tax Administration, 1990; *The Japanese Tax System*, Professor Hiromitsu Ishi, Clarendon Press, Oxford, 1989;

6 Report on Japanese Taxation, Professor Carl S. Shoup, 1949

CHAPTER 12

SUMMARY

THIS STUDY HAS been concerned with the practical implications of a local tax on incomes. It has not sought to answer the main question of policy, whether a local income tax is or is not desirable. In the final analysis, that will turn on much wider constitutional, economic and political judgements. That said, the policy and the practicalities, as always, interact. There are limits beyond which one cannot sensibly decide questions of structure without regard to finance, or sources of finance, such as a local income tax, without regard to what they might look like, how they might work, and what they might cost.

A number of things have moved on since Layfield reported in 1976. For example, in terms of the general balance of taxation, Chapter 11 has discussed the extent to which fiscal policy has increasingly to be decided against a background of European commitments and, more directly important for many of the developments discussed in this note, international competition.

Within the UK the tax administration has seen a series of developments and proposals with (in certain ways) linked objectives:

- Improving customer service (in particular, bringing together the whole of a taxpayer's tax affairs in a more convenient and intelligible way and - very relevant for that purpose - finding a simpler way of taxing the self-employed);

- Reducing costs (in particular, reducing both the amount of routine processing work, and the cost of that which needs must be done);

- Handling large numbers of new small claims for repayment of tax on investment income (in particular, following independent taxation and the new arrangements for taxing bank and building society interest).

As a result of these developments, in hand or in prospect, the Inland Revenue has, or may in any event be acquiring, new capabilities - to reduce the costs of processing bulk returns, and to bring together, where that is available, information about a taxpayer's total income, the tax due on that, and his or her address - which it did not have in 1976, which are relevant to present taxation policy, but which other countries clearly find helpful, where they run a local income tax.

For purposes of tax administration, the Inland Revenue, local authorities, large employers, financial institutions, and accountants and other tax agents all now have sophisticated IT support, of a kind that did not exist in 1976; and the technology exists, to allow them to communicate with each other, where they need to, electronically, without precipitating a blizzard of new paper. As always, changes in tax systems would require changes in their IT support. But that is part of the never-ending business of managing change. It is no longer a separate and additional constraint.

However, a number of things still stand in the Layfield analysis. It remains relevant that, under the present system:

- The Revenue does not have figures of total income for many employees;

- Nor does it have up-to-date and reliable information about their addresses;

- A taxpayer with multiple sources of income may have his tax affairs dealt with by different tax offices up and down the country;

- And his tax liability for any fiscal year may relate to streams of income earned in quite different calendar periods.

It remains true that large numbers of small employers do not yet have access to high-quality IT support, and that their costs, even in running PAYE for a single national income tax, are relatively high. It remains the fact that any effective local income tax would need to handle certain important, but on the evidence not unmanageable, issues such as local residence, local authority cash flow and equalisation of resources between richer and poorer authorities.

Figure 2

	Local discretion				**Performance against criteria**						
	Local authority sets rate	Local authority assesses/collects tax	Local authority establishes taxable income	Local authority defines tax base	Local responsibility/power of decision	Local accountability/perceptibility	[illegible]	Cheap to run	Easy to collect in-year	Can be introduced relatively quickly	Taxpayer confidentiality
	(i)	(ii)	(iii)	(iv)	A	B	C	D	E	F	G
Option A Hypothecated Tax	O	O	O	O	L	L	H	H	H	H	H
Option B Layfield a Tax	X	O	O	O	M	L	L	M/L	H	@	H
b	O	O	O	O	L	L	H	H	H	H	H
Option C Local surcharge	X	O	O	O	M	L	L	L	H	@	H
Option D Locally collected tax	X	X	O	O	H	H	H	@	M	@	M
Option E Operationally freestanding tax	X	X	X	O	H	H	H	L	L	@	L
Option F Wholly freestanding	X	X	X	X	H	H	H	L	L	@	L

Layfield a - earned income b - investment income

Key

O = no
X = yes

H = scores highly
M = scores moderatly
L = a low score
@ = Depends on the form of the tax

It remains the fact that different forms of local income tax would have very different implications for local responsibility and accountability, for confidentiality and other criteria, and for the costs of all parties; that any local income tax which significantly added to local accountability would have significant administrative costs (which on the assumptions in this paper would be in addition to the costs of administering the Council Tax); and that it must be for political judgement to balance the costs of each option against the benefits. Figure 2 attempts a very summary illustration of how the various main Options score against the main criteria listed in Chapter 3.

It remains the fact that any substantial new local income tax (that is, other than a simple hypothecation of the national income tax) would take several years to put in place - the necessary time depending very much on the precise details, and on the degree of priority that the change was given by the government of the day.

Hypothecation, or the assignment to local authorities of a share in the national income tax is listed as Option A. It has not attracted many advocates. It would not, of itself, give to local authorities any guarantee as to their future income (though it may be said that hypothecation has, as a matter of history, been anathema to orthodox Treasury policy precisely because it tends to constrain the Chancellor's freedom of budgetary manoeuvre). Its impact might be largely presentational (though it may be said that it is only through the perception of facts that people can in any event be motivated). In terms of local responsibility and accountability, an hypothecated tax must rate at best a low score. Overall, it could perhaps deliver a strictly limited objective at a relatively low cost.

Within the present UK tax structure - and in particular the present cumulative PAYE arrangements - the practicalities and potential costs still argue persuasively against any approach that:

- Required taxpayers to submit, and the authorities to process, very large numbers of additional tax returns at the year-end, so that many millions of taxpayers needed to have their tax affairs handled up to three times in a single year.

- Sought, by the same token, to charge local income tax, at locally variable rates, on investment incomes generally.

Thus, if a local income tax needs to run concurrently with the present national tax arrangements, the balance of arguments still points towards something on the lines suggested by Layfield - Option B. Under this approach, local income tax is based firmly on the national tax, with precisely the same base, reliefs etc. and rules. Local authorities are responsible for setting a rate of tax on earned income, but local income tax is fixed at a uniform flat rate on investment income. The tax is operated and collected by the Inland Revenue, alongside and very much as part and parcel of the national income tax. The Inland Revenue passes on the proceeds to local authorities on the basis of the local rates of tax (as they apply to earned incomes) and an estimate of the total amount of incomes in each local authority area.

A local income tax of this kind would require the Inland Revenue to acquire annually from the great majority of taxpayers, and communicate to employers, information not needed for national tax purposes. At the time of Layfield it was estimated that the staff cost to the Revenue might be in the region of 12,000 to 13,000 man-years - or perhaps 25 per cent less with the then envisaged IT support. Modern technology might reduce those costs significantly. However, the numbers are so great that the costs would still necessarily be substantial. And they would all be additional to the costs of the national tax system, which already involves relatively high public sector (though not overall) operating costs. In return for those costs, there are substantial questions about the effectiveness of an Option B scheme for local responsibility and accountability. There would be possibly significant additional compliance costs for employers, particularly the smaller employers. And there would be practical constraints on the number of local authorities that could charge a local tax, and the range of tax rates that they could charge.

Wider possibilities would open up, if it were possible to relax the assumption that the UK continues with its present tax arrangements, and in particular with the present cumulative PAYE. The alternative might be a much more broad-brush deduction of

tax from employment income during the year, followed by an end-year return of income and an end-year assessment (either Revenue assessment or self-assessment), on the basis of which the taxpayer pays any additional tax due, or (commonly) claims a repayment of tax overpaid. Judged by other countries' experience, a tax system of that kind might have overall (public plus private sector) costs not very different from those of the present UK system. But the public sector costs might be substantially lower (very crudely, the public sector saves more, by no longer trying to get the taxpayer's payments precisely right during the year, than it loses, by having to handle a great many more returns at the year-end). The compliance costs of the private sector might be correspondingly higher.

There are advantages and disadvantages in both kinds of system. Inevitably, change itself always has a cost; and for the Revenue a change to a non-cumulative PAYE, with general arrangements for end-year assessment, would probably mean a physical reshaping of the local office network. The timetable would need much detailed work by all the bodies that would be involved in the operation, on the basis of clearly specified proposals, before one could confirm or improve the old Layfield estimate of "five years". More generally, Layfield concluded that not many governments would be likely to change their national tax arrangements solely for the purposes of a local income tax. However, if a local income tax were thought desirable in principle, that could be one significant factor to be weighed in judging the balance of advantage.

One possible approach, if one were to assume an alternative PAYE system of this kind, is outlined as Option D in this paper. As in the Layfield approach, it is assumed that a local income tax retains the same tax base (the same personal allowances, reliefs and deductions) as the national income tax. Under the alternative, non-cumulative PAYE arrangements, however, the taxpayer now makes a regular annual return of income for national tax purposes; and this return contains the information about total income and residence essential for a local income tax. In Option D it is assumed that this same return can be used for both national and local income tax purposes - and thus that the marginal cost of getting the raw material for a local income tax is very much less than in Option B.

It would be possible, under an approach on these lines, for local authorities to set local (locally variable) rates of income tax, not only for earned income, but also for investment income. Under one possible variant (in effect, a compromise between Options C and D in the paper) the Inland Revenue might handle all the operational work of a local income tax, as in the Layfield proposals. A scheme of that kind would have much the same implications for local perceptibility and accountability (though with an added impact on investment incomes), and for example for confidentiality, as the original Layfield scheme - but with a much lower marginal cost to the Inland Revenue.

Alternatively, the Inland Revenue might, under such a scheme, pass to the local authorities the information about taxpayers' total incomes (but not necessarily details of how those incomes are made up); and the local authorities might be responsible for collecting the local tax from, or repaying it to, their local electors. That would require a massive (and, crucially, reliable) exchange of data between the Revenue and local authorities. However, the technology does not appear unmanageable, provided that no political objection is seen to the sharing of a common register between the central and local tax authorities. So far as possible, local authorities would obviously align or integrate collection arrangements with those for the Council Tax; and the costs might in any event be much less, to the extent that the end-year adjustment could take the form of a repayment, not a demand for additional tax. On any basis, however, collection would be a significant new cost to local authorities, to be weighed against the gains for local accountability.

Under either variant of Option D, withholding arrangements would be important, for the security of a local income tax, for its costs of collection, and for the important minority of cases where it would in practice be difficult to identify the local residence of an employee at the time of payment, or to trace employees who have recently left. Under one variant, perhaps a variant modelled more closely on Layfield, employers might be required to deduct tax at the correct local rate. Under another variant, employers might deduct at a flat rate - with significantly lower compliance costs but at some possible sacrifice of local perceptibility - leaving the correct

liability to emerge in the course of the end-year adjustment.

At the far end of the spectrum, there are overseas countries where the local income tax is more or less completely free-standing (Options E and F) and where at the extreme local authorities are responsible, not only for setting a rate of local income tax, and for collecting it, but also for the full range of tax policy - the tax threshold, the progressive schedule of tax rates, tax reliefs and allowances, and so forth. Layfield argued that this would:

> "give local authorities a very wide ability to manipulate and shift burdens of taxation between individuals and between areas; we consider that such freedom would not be an appropriate characteristic of a local tax."[1]

The policy debate aside, a local income tax of this kind would be bound to entail substantial further costs for both public and private sector. Costs on that scale may have developed in some countries in the special context of a federal constitution and may be accepted as unavoidable in that context. As has been said before, questions of local authority structure and finance cannot rationally be decided in isolation, one from another. There must be a question whether a fully free-standing local income tax could be justified in the context of anything resembling the UK's present constitutional arrangements.

Notes

1 Cmnd. 6453, Annex 24.

APPENDIX

Table 1: Sources of finance

England and Wales		
1991-92 Budget plans	£m.	(%)
Total Revenue expenditure	49,264	
Financed by:		
Special grants and other income	10,654	(22)
Community Charge	8,895	(18)
Government contribution to Community Charge	5,120	(10)
Revenue support grants	12,238	(25)
Non-domestic Rates	11,731	(24)
Use of Reserves	626	(1)
Scotland		
Estimated net expenditure on services	4,708	
Financed by:		
Specific grants	308	(7)
Standard Community Charge	14	(..)
Personal and Collective Community Charge	1,015	(22)
Revenue support grants	2,414	(51)
Non-domestic Rates	1,023	(22)

Sources:
England and Wales; Finance and General Statistics 1991-92. (CIPFA, July, 1991)
Scotland: Rating Review Estimates of Income and Expenditure 1991-92.(CIPFA, June, 1991)

Table 2: Regional pattern of expenditure and finance

	% by region					
	A	B	C	D	E	F
I England and Wales						
South East	36	33	35	36	55	45
East Anglia	3	4	4	3	3	4
East Midlands	7	8	8	7	5	7
North	6	7	6	7	4	4
North West	14	14	12	14	8	10
South West	8	10	9	7	7	9
West Midlands	10	11	10	11	7	9
Yorkshire and Humberside	10	9	10	10	7	8
England	94	97	94	94	96	96
Wales	6	3	6	6	4	4
England and Wales	100	100	100	100	100	100
II Great Britain						
England	86	87			89	89
Wales	5	3			3	3
Scotland	9	10			8	8
Great Britain	100	100			100	100

Sources:
A I: Total Revenue expenditure,1991-92 (CIPFA, ibid.)
A II: Net expenditure on services (CIPFA, ibid.)
B: Community Charge (CIPFA, ibid.)
C: Government Contribution to Community Charge (CIPFA, ibid.)
D: Specific grants (CIPFA ibid.)
E: Notional UBR contribution to NDR (CIPFA, ibid.)
F: Regional analysis of income tax from the 1988-89 Survey of Personal Incomes (Inland Revenue Statistics, 1991)

Table 3: Regional pattern of expenditure and finance

1991-92 Budget estimates, £m.

I England and Wales	A	B	C	D	E	F
South East	17,633	2,975	1,770	1,999	6,494	6,449
East Anglia	1,659	364	211	174	399	583
E. Midlands	3,523	742	407	380	636	1,070
North	3,134	592	311	383	419	600
N. West	6,657	1,274	629	781	970	1,437
S. West	3,862	886	483	403	819	1,259
W. Midlands	5,133	1,005	526	613	811	1,283
Yorks and Humber	4,756	804	493	546	770	1,129
England	46,357	8,644	4,830	5,279	11,318	13,810
Wales	2,907	252	290	349	413	539
England and Wales	49,264	8,895	5,120	5,628	11,731	14,349
II Great Britain						
England	40,485	8,664			11,318	13,810
Wales	2,527	252			413	539
Scotland	4,708	1,015			1,023	1,197

Sources: as for Table 2. The figures shown for 'income tax' in column F are the 1988-89 figures, notionally uprated by 1.37, to proxy the increase in tax between 1988-89 and 1991-92; divided by 4 as a broad approximation to the yield of a tax rate of between 6 and 7p in the £.

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LOCAL INCOME TAX
A STUDY OF THE OPTIONS

AJG Isaac

There has been - and undoubtedly will continue to be - much debate about how far local authorities should be free to decide their own spending and other priorities within their own areas. Is it appropriate to place in the hands of local authorities a tax as buoyant and as sensitive as an income tax?

But such a tax need not necessarily replace existing local taxes (such as the council tax); it could stand as a supplement to them. What form might such a tax take? What are the main options? What would they be likely to entail? How far would each option achieve the likely main objectives, or avoid the main problems?

In this study AJG Isaac, a Deputy Chairman of the Board of Inland Revenue until 1991, reviews six main options for a form of local income tax, with possible variants, setting the scope for change in the context of the unusual UK system for taxing employment and other income and likely developments in the system. The author identifies seven main criteria by which a local income tax might be judged, tackling the special problem of the residential qualification for such a tax, and measures the main options against these criteria. He looks at the implications which might be drawn from the way other countries arrange their local income taxes.

Finally, he assesses which options are the most realistic given the current constraints of the national tax system. The report does not set out to answer the main question of policy: is a local income tax desirable? But it proves a valuable analysis of the viability of such a levy, within the limits of the much wider constitutional, economic and political judgements in which any decision would have to be made.

This study was undertaken as part of the research programme of the Local and Central Government Relations Committee of the Joseph Rowntree Foundation.

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